ENTREPRENEURSHIP AND COMPETITIVE STRATEGY IN THE NEW SMALL FIRM: AN EMPIRICAL INVESTIGATION

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DECLARATION

I declare that this thesis has been composed by myself and that the work incorporated in it is my own.

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ABSTRACT

Entrepreneurship is usually associated with the small (i.e. owner-managed) firm. The small, rather than the large, firm is often recognised for exhibiting innovation, profit maximisation, and risk-taking. And, it is the setting-up of a new firm (which is typically small by nature) that is the most obvious example of entrepreneurship.

This thesis is concerned with the direct investigation of the inception and development of the new small firm. The objective is to increase awareness and understanding of the new small firm without being critical or judgmental; a positive, rather than normative, approach is taken.

A data base containing numerical and textual information was established by fieldwork methods. The instruments of investigation include an administered questionnaire and a semi-structured interview. The administered questionnaire contains 5 sections: (1) General; (2) Pricing; (3) Costing; (4) Sales and Competition; and (5) Finance. The semi-structured interview contains 3 sections: (1) Competitive Forces; (2) Competitive Strategy; and (3) Defensive Strategy.

The sample consists of 73 new small firms in Scotland. The sampling procedure used was judgmental or non-probabilistic. The Edinburgh Venture Enterprise Trust, Glenrothes Enterprise Trust, Irvine Development Corp., Leith Enterprise Trust, and Scottish Development Agency assisted in the establishment of the sample.

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CONTENTS

CHAPTER I

Introduction

Entrepreneurship is, perhaps, most closely identified with the small firm. And, it is the founding of a new firm (which is generally small by nature) that is the most visible form of entrepreneurship. It is the small, rather than the large, firm that is renowned for displaying innovation, profit maximisation, and risk-taking. Alternatively, the large firm is recognised for reacting to, rather than initiating, innovation, maximising such objectives as sales revenue and management emoluments, rather than profits, and reducing its exposure to risk by means of diversification and mergers. Joseph Schumpeter [1943] presented in his classic book, Capitalism, Socialism, and Democracy, the thesis that the very success of capitalism would lead to its self-destruction and "march into socialism". The result of successful entrepreneurship would be an economy dominated entirely by a few large firms. Moreover, these firms would grow or "mature" to the point where management was separated from ownership. Consequently, conduct in such firms would be characterised by routine and bureaucracy with the entrepreneurial function becoming obsolete. Therefore, it is in the small (i.e. owner-managed) or "immature" firm where entrepreneurship can best be expected to flourish (at least potentially).

The importance of the small firm sector in the UK economy in generating economic growth has never been more emphasised than it has over the past few years. Since the appointment of the Bolton Committee in 1969 to examine the disadvantages suffered by small firms, there has been a growing conscious effort by Governments (both Labour and Conservative) to remove market and political prejudices (e.g. limited access to finance, lack of legislation to encourage competition, and unfair taxation). In recent years, Government policy has shifted from being non-discriminatory to actively encouraging growth in the small firm sector. For example, the Government has introduced such initiatives as The Enterprise Allowance Scheme, The Business Expansion Scheme, and The Loan Guarantee Scheme.

The promotion of small firms is in recognition of the necessary restructuring of the UK economy away from being heavily dependent on a few hundred large enterprises. At present, the level of aggregate industry concentration in the UK is probably greater than any other Western industrialised economy. According to Utton [1984], "it is still likely that in the near future half of manufacturing output in the UK will be produced by the 100 largest firms". [p.5] Of course, industry concentration naturally grows according to what is commonly referred to as Gibrat's law or "spontaneous drift". However, according to Prais [1981], <u>half</u> of the growth in industry concentration in the UK is attributed to significant technical and systematic factors (e.g. production economies of scale, transport and communications, advertising and finance). These factors have not only meant a general bias towards large firms, but little productive benefit has resulted. The most direct means of rapid concentration growth has been mergers and takeovers. Prais [1981] argues that about one-third of the recent growth of the largest UK companies may be attributed to mergers. In the United States, however, the figure is more like one-tenth. This difference suggests a notable gap between UK merger controls and US antitrust laws. According to Samuels and Morrish [1984], the increase in merger and takeover activity in the UK over the past two decades has not resulted in higher profitability or even increased levels of investment. (Samuels and Morrish cite the studies by Whittington [1980] and Singh [1971] as supporting evidence.) It is generally admitted that Britain has for far too long suffered under the delusion that, in order to compete successfully in the international market and create economic growth and employment, large firms are to be encouraged at the expense of the small and medium firm sectors. The argument is not that there should be fewer large firms, but a more balanced industrial structure featuring more smaller firms.

This thesis is concerned with the direct investigation of the inception and early development of small firms in Scotland. As Hood and Young [1984] announced, "the statistical base in the proposed area of research is weak and urgently needs to be improved, and further work is needed to identify the general principles governing the growth of new enterprises in Scotland." Therefore, by examining first-hand the conduct of owner-managers, it is hoped that a better understanding has been attained of how small firms not only start, but survive, prosper, and perhaps ultimately become large firms. The investigation was subjective in nature and based on the opinions of the owner-managers; given that businessmen often act according to their own opinions, it seemed important to inquire about those opinions [Reid, 1981]. Moreover, the investigation was positivist, rather than normative, in its approach. Again, the purpose of this research was to increase awareness and understanding, rather than to be judgmental and critical, of the nascent small firm.

Chapter II examines entrepreneurship within a Schumpeterian perspective. This concept has long been plagued with many differing treatments resulting in much misunderstanding and misuse. Thus, it is important to establish early on what is meant by entrepreneurship in the thesis. Schumpeter's assessment of the concept is adopted given his incomparably thorough and rigorous approach as revealed in his comprehensive writings. His analytical treatment of entrepreneurship as "the fundamental phenomenon of economic development" remains unsurpassed in its clarity and precision. Essentially, Schumpeter's entrepreneurship refers to innovation or "carrying out new combinations", whereby a new production function is created. An obvious example of entrepreneurship is the founding of a new firm. Successful innovation is measured by its resulting profits. Furthermore, it is argued that the entrepreneurial function pervades all business activities in an often "humble" and "temporary" manner.

Chapter III is particularly concerned with the recent major contributions of Michael Porter [1980 and 1985]. Essentially, Porter (with the assistance of others) has bridged a significant gap between industrial organisation and business strategy. Since the pioneering work of Edward Mason and Joe Bain, economists studying industrial organisation have been primarily interested in the impact market structure has on market performance, whilst assuming that firms' conduct (strategy) has no notable influence on either performance or structure. These economists were concerned with the development of competition policy and focused their attention strictly on industry as the unit of analysis. Business strategy, however, treats the firm as the unit of analysis and is concerned with improving the firm's performance. Business strategy is the dynamic or entrepreneurial element of a firm's activities. Porter's contribution is a framework by which a firm can assess the competitive forces - i.e. rivalry (existing and potential), customers, suppliers, and substitutes - which determine the kind of competitive strategy - i.e. low cost, differentiation, and focus - undertaken. Moreover, Porter introduces the "value chain" as a tool by which a firm's activities can be systematically disaggregated in order to formulate and implement competitive strategy to achieve competitive advantage.

Chapter IV discusses the methods of investigation used in the research as well as the derivation and characteristics of the sample. The formulation of the administered questionnaire and semi-structured interview was preceeded by important unstructured design work. This stage of the research involved spending three months with an enterprise trust as a consultant. This opportunity offered direct insight into the problems small firms faced in their inception and early years. This experience was of immense aid in influencing the formulation of the methods of investigation and interpreting the data.

The administered questionnaire involves 5 sections: (1) General; (2) Pricing; (3) Costing; (4) Sales and Competition; and (5) Finance. The General section is concerned with information regarding a firm's industrial classification, number of employees, sales revenue, main product group, principal market, market share, number of competitors, and characteristics of customers. The Pricing section examines such aspects as price determination and the affects of a boom and recession on pricing decisions. The Costing section looks at, for example, a firm's capacity level, fixed and variable costs, and changes in output. The Sales and Competition section analyses price changes under varying business conditions, reasons for altering selling price, and forms of competition from rival firms. Finally, the Finance section considers such matters as obstacles to obtaining finance, security, "gearing" (leverage) ratios, cash flow difficulties, and expansion plans. The content of the first four sections and the administered questionnaire's overall design is attributed to Dr. Gavin C. Reid. The administered questionnaire was conducted amongst 73 small firms in Scotland.

The semi-structured interview adopted Porter's framework and contains 3 sections: (1) Competitive Forces; (2) Competitive Strategy; and (3) Defensive Strategy. The design of the semi-structured interview is credited to Dr. Reid. It was conducted amongst a sub-set of the sample.

Chapter V examines the findings from the semi-structured interview. The approach is integrative, rather than attempting to analyse each firm on its own merits. Looking at comparisons and contrasts between firms seems a more useful means of increasing our understanding of how new small firms assess competitive forces, formulate and implement competitive strategy, and sustain competitive advantage. Some of the information from the administered questionnaire data was useful in the analysis.

Chapter VI inspects the data from the Finance section of the administered questionnaire. An investigation of entrepreneurship and competitive strategy would seem to be incomplete without assessing the financial needs of inception and development. The inability to obtain sufficient finance is the fundamental deterrent to entrepreneurship. Schumpeter [1934] certainly agreed and argued at great length about the importance of bank credit to the entrepreneur in his influential book, The Theory of Economic Development. Finance is a particular concern for the new small firm since it invariably starts undercapitalised and often confronts serious cash flow problems.

Chapter VII summarises the findings from Chapters V and VI and what they might suggest. Also, further possible academic work as derived from the established data base is discussed.

CHAPTER II

Entrepreneurship: A Schumpeterian Perspective

Introduction

Entrepreneurship, perhaps more than any other concept in economics, has been much maligned with seemingly confounding and contradictory assessments. It may well be the beauty of the beast. After all, one merely needs to travel through the history of economic thought beginning with Cantillon to appreciate the evolving character or transformation of the concept of entrepreneurship that has unfolded. Moreover, the study of entrepreneurship extends beyond the attention and care of economics into the disciplines of psychology, sociology, history and business studies.

Joseph Schumpeter, probably more than anyone else, appreciated the complexity of the beast, as his richly comprehensive writings bear witness. His treatment of entrepreneurship as "the fundamental phenomenon of economic development" possesses a clarity and analytic precision which had been hitherto unattained. Consequently, any assessment of Schumpeter's contribution must not neglect a comprehension of his model of economic development. In Schumpeter's schema, entrepreneurship is an endogenously generated factor. This approach is at odds with neoclassical and Keynesian theories of development that rely on changes external to the model, whether they be changes in resources, preferences, or technology. In such analyses, Schumpeterian entrepreneurship is defined out of existence. Moreover, Schumpeter is insistent that economic development be cyclical and _not_ depend on some underlying trend as do some conventional schemas. Thus, with "desperate brevity" (to use Schumpeter's phrase), the first section of this paper seeks to lay down Schumpeter's Circular Flow. Only within this "ideal" context can the introduction of the disruptive element, innovation, have any distinct and significant meaning as the entrepreneurial function. The Circular Flow, in Professor Loasby's [1984] words, serves as "a condition of innovation because it generates the stable data which make rational calculation possible."

In the second section, we are in a position to come to grips with the rather controversial aspects of Schumpeter's conception of entrepreneurship. Specifically, by observing the inadequate portrayals of the entrepreneurial function by Cantillon, J. B. Say, J. S. Mill and Marshall, as depicted by Schumpeter, it will be seen that indeed the entrepreneur is not the bearer of risk. More important, entrepreneurship should not be viewed in terms of a person, but as a function that pervades all activities of business in an often "temporary" and "humble" fashion. Moreover, attention is called to the necessity of all business activities and their "routine ways" to _effect_ entrepreneurial success.

The Circular Flow and Innovation

The brilliance of Schumpeter's ability to capture and establish the entrepreneurial function as the _sine qua non_ of economic development is found in his utilization of static or stationary analysis. His schema, which involves what he calls the Circular Flow, is essentially similar to that of a Walrasian equilibrium state. Such an unrealistic construct, as Schumpeter [1939] argues, "... is useful and indeed indispensable for purposes of analysis and diagnosis, as a point of reference. Actual states can conveniently be defined by their distance from it". [p.69] But, before "actual states" can be properly examined, meticulous attention must be given to ascertaining the equilibrium state. As Schumpeter [1939] makes quite plain:

> The first and foremost task of economic analysis is to explore the properties of that system.... This is the magna charta of economic theory as an autonomous science, assuring us that its subject matter is the cosmos and not a chaos. It is the rationale of the idea of variables that do not vary, the justification of the schema of a stationary economic process. [p.41]

In Schumpeter's Circular Flow or Theoretical Norm, we find an economic state totally uncomplicated or undistrubed by capricious change.[1] More precisely, change is not discontinuous or spontaneous, but predictable and inconsequential in the routine

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1. Schumpeter's concept, the Circular Flow is similar to what Mises described as an "evenly rotating economy". Mises [1949] stated: "But in the evenly rotating economy change and succession of events are eliminated. Action is to make choices and to cope with an uncertain future. But in the evenly rotating economy there is no choosing and the future is not uncertain as it does not differ from the present known state.... it is a world of soul-less unthinking automations..." [p. 249] Moreover, Mises argued that such a state was necessary to an understanding of change. "It is therefore preposterous to maintain that the construction of an evenly rotating economy does not elucidate conditions within a changing universe and to require the economists to substitute a study of 'dynamics' for their alleged exclusive occupation with 'statics'. This so-called static method is precisely the proper mental tool for the examination of change". [p.248] For an interesting and persuasive argument for Schumpeter's inclusion in the Austrian School, see Simpson [1983].

affairs of the economic subjects. Consequently, we find an essentially repetitive and harmonious economy, dominated by consumption, which is found to run on, year in and year out, in essentially the same fashion. In such a state where "everyone will cling as tight as possible to habitual economic methods", it could be argued that the economic subjects are a complacent and agreeable lot.[2] Schumpeter [1934], in describing his Circular Flow, writes:

> We can imagine that, year in and year out, every recurring employment of permanent sources of productive power endeavours to reach the same consumers. The result of the process is in any case the same as if this happened. Hence it follows that somewhere in the economic system a demand is, so to say, ready awaiting every supply, and nowhere in the system are the commodities without complements.... It follows, again from the fact that all goods find a market that the circular flow of economic life is closed, in other words that the sellers of all commodities appear again as buyers in sufficient measure to acquire those goods which will maintain their consumption and their productive equipment in the next economic period at the level so far attained, and vice versa. [p. 8]

However, because this Pure Model[3] is void of disruptive innovation and its consequential profits, economic development is hopelessly elusive. Schumpeter [1934] argues that this "dynamic" phenomenon, innovation, is "entirely foreign to what may be observed in the circular flow or in the tendency towards equilibrium. It is spontaneous and discontinuous change in the

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2. In his famous chapter, "On the Stationary State", Mill [1848] discusses the desirability and necessity of such a "Utopian" state.
3. See Clemence and Doody [1950] for a concise and accurate appraisal of Schumpeter's schema.

channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing". [p. 64] Furthermore, development is that kind of change arising from within the system "which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps". [p. 64n]

The single causative factor of economic development is innovation, which is defined as "doing things differently in the realm of economic life" (or, more precisely, setting up a new production function by "carrying out new combinations"). If this were interpreted to mean no more than that "the cause of change is change", it would, of course, be a mere tautology; but such an interpretation would be an injustice to Schumpeter's intention.[4] He is quite specific regarding the acts constituting innovation. Schumpeter [1939] states:

> By changes in the methods of supplying commodities we mean a range of events much broader than the introduction of new commodities which may even serve as the standard case. Technological change in the production of commodities already in use, the opening up of new markets or of new sources of supply, Taylorisation of work, improved handling of material, the setting up of a new business organisation such as new department stores... all these instances of what we shall refer to by the term Innovation. [p. 84]

It is clear that Schumpeter's idea of innovation is quite inclusive in respect to both technical and organisational forms. Indeed, we find Schumpeter to be explicit and exacting in his

4. This argument is attributed to Sweezy [1943].

use of the concept.[5]

Innovation is introduced into the Circular Flow by the entrepreneur, the primum mobile of economic development. Schumpeter confidently asserts that innovation, the systems' "prime mover", is the single cause of economic change (i.e. shaking the Circular Flow out of its lethargic equilibrium state). This assertion that the model, by permitting only this one cause to operate, is a comprehensive theory of economic change has invariably fallen prey to criticism. For example, Kierstead [1948] in his book, The Theory of Economic Change, stated:

> The more recent writings of Professor Alvin Hansen, with a pessimistic tone resembling in some ways that of Karl Marx, require of us a critical approach to Schumpeter's system. Professor Hansen believes that there are three given and external causes of economic change, which act more or less independently. Professor Schumpeter does not explicitly deny these other causes. On the contrary, he insists on the complexity of the causes of change. But he does select a model for analysis in which only one cause is allowed to operate. We do not intend to be understood that this is not valuable analysis, and a perfectly proper use of limitation and selection. It is, however, distinctly limiting, and precludes the possibility of a comprehensive theory of economic change. Professor Schumpeter's general optimism would be dimmed, perhaps, by a study of other models, in which other causes present in the real world, were allowed to operate. [p. 97]

5. Lange [1943] considers Schumpeter's definition of innovation to be "too wide". Since innovation is defined as simply "setting up a new production function", Lange asserts that innovation could therefore include an infinite number of possibilities. However, a firm will only choose changes that will possibly be profitable and disregard all others. This argument should be at least implicitly obvious in Schumpeter.

Clemence and Doody proposed that Kierstead's criticism is not valid upon inspection of Hansen's three causes of change and find that they are indeed consistent with Schumpeter's all-embracing concept, innovation. To quote Hansen [1941]:

> ... the constituent elements of economic progress are: (a) invention, (b) the discovery and development of new territory and new resources, and (c) the growth of population. Each of these in turn, severally and in combination, has opened investment outlets and caused a rapid growth of capital formation. [p. 352]

As noted earlier, Schumpter's specific activities constituting innovation include the development of new resources and new markets, thus bringing a phenomena related to territorial expansion within the scope of the analysis. Of course, inventions refer to the scientific forerunner of commercially applied innovations. Not all inventions, however, lead directly to economic fruition. Schumpeter is quite adamant in distinguishing innovation from invention. For example, Schumpeter [1934] states, "as long as they are not carried into practice, inventions are economically irrelevant." [p. 88] Of course, innovation need not always be a consequence of invention.

The issue therefore reduces to the question of population, and to whether or not the exclusion of population changes from the model precludes the possibility of a comprehensive theory of change. Schumpeter [1939], of course, anticipates this criticism:

> Increase in productive resources might at first sight appear to be the obvious prime mover in the process of internal economic change. Physical environment being taken as constant, that increase

> resolves itself into increase of population and the increase of the stock of producers' goods. Neither can, of course, be treated as an independent variable; both are at the same time effects of economic changes and conditions of other economic changes. Our reason for listing variations in population among external factors was that there is no unique relation between them and variation in the flow of commodities. Hence, it seemed convenient for our purpose, although it would be inadequate for others, to look upon an increase in population as an environmental change conditioning certain phenomena. Moreover, it could be demonstrated by familiar cases (India and China) that a mere increase in population does not bring about any of these phenomena which presuppose either a certain density or a certain rate of increase in population except a fall in real income per head. Finally, it occurs so continuously as to be capable of current absorption. Short-time variations in marriage rates are obviously the reflex of business fluctuations, and do not cause them. [p. 74]

Essentially, because of empirical evidence (viz. India and China) showing no relation of a unique sort between population growth and commodity flows, it is convenient to minimise discussion of population growth.

It is generally acknowledged that Schumpeter's concept of innovation is nothing short of being bold, perhaps even obtrusive. Only with the introduction of "new combinations" can the Circular Flow be jolted out of its dull and lifeless pattern. As Schumpeter [1939] states: "Those disturbances must necessarily be 'big' in the sense that they will disrupt the existing system and enforce a distinct process of adaption which should show up as such in any time series material ... individual innovations imply, by virtue of their nature, a 'big' step and a 'big' change". [p.101]

The success of innovations, moreover, pave the way for subsidiary and/or competitive innovations. These induced innovations, as well as imitations, "cluster" in the wake of the initial innovations. Consequently, innovations do not occur as either isolated events or distribute randomly over the whole of the economic system. The time frame of initial, and the consequent induced, innovations and their "followers" can be rather extensive depending on the magnitude of the perturbations. The more robust the innovations, the longer is the length of time required for their effects to work themselves out into a new Circular Flow. Of course, the "ideal" state of the Circular Flow, where uncertainty or ignorance is nonexistent, prevails once innovations have been entirely exhausted in the sense that they have been adapted or transformed into routine. Schumpeter hesitantly admits the prevalence of equilibrating forces and prefers to speak of "neighbourhoods of equilibrium" rather than actual states of equilibrium.[6]

Though Schumpeter [1939] asserts in familiar style, "the history of capitalism is studded with violent bursts and catastrophes" [p.102], induced innovations and imitations are not to be relegated to an after-thought or simply dismissed as anything less than entrepreneurial (though Schumpeter seems to suggest otherwise). The time lag of induced innovations and imitations can be so extensive given their degree of success that one can

6. Taussig [1921] shares Schumpeter's reluctance to speak of an equilibrium point and alternatively speaks of a "penumbra of prices". As he states, "In reality, however, as everyone knows, fluctuations persist. There _is_ a penumbra within which market prices fluctuate."

easily forget or lose sight of the initial and responsible perturbations. Of course, Schumpeter is explicit in his concern for small as well as big "new combinations". To quote Schumpeter [1939]: "We must try to divest ourselves of the idea that innovation necessarily means something spectacularly important..." [p. 92] Elsewhere, he [1947] writes, "It need not be Bessemer steel or the explosion motor. It can be the Deerfoot sausage." [p.151]

The modus operandi of Schumpeter's schema is Creative Destruction; i.e. the created markets and accompanying profits are reduced and then annihilated by those who recognise a "good thing" and want, in the vernacular, a "piece of the action" (viz. profits). Induced innovations and imitations are easier to effect but remain nonetheless entrepreneurial, in a relatively modest sense, as long as "new combinations" are being carried out and profit is the enticing reward.[7] Schumpeter [1939] states: "... whenever a new production function has been set up successfully and the trade beholds the new thing done and its major problems solved, it becomes much easier for other people to do the same thing and even to improve upon it. In fact, they are driven to copying it, if they can and some people will so forthwith." [p.100] Schumpeter is suggesting that imitation

7. Schumpeter is careful to avoid referring to "induced innovations" and "imitations" as anything but consequences or adaptations to entrepreneurial distrubances to the Circular Flow. Allowing what would be equilibrating (Kirznerian) activities to be deemed as "entrepreneurial" would relax the significance of what Schumpeter saw as "fundamental" to economic development i.e. disequilibrating innovation.

(and certainly induced innovation) is not necessarily automatic.[8] The imitator may or may not achieve a "piece of the action".

Moreover, such equilibrating tendencies are invariably incomplete, given the concomitant security and certainty, which will foster further competitive reactions or initiatives in the form of entrepreneurial disruptions to the Circular Flow. As long as profit (and its consequent personal rewards) remains the motivation, innovation will ensure the elusiveness of the Circular Flow as an actual state of the world.

The Management, Capitalist, and Entrepreneurial Functions

Schumpeter [1934] makes the apparently provocative statement, "the entrepreneur is never the risk bearer". [p.137] A proper investigation of the attendant qualifications reveals a logical and plausible argument which essentially draws a particular and necessary distinction between the entrepreneurial function and the capitalist and management functions that economists have largely neglected. Economists in the tradition of Cantillon and J. S. Mill have successfully cloistered the capitalist function - i.e. providing the financial and/or productive means - within the entrepreneur due to the pre-eminent concern of placing risk-bearing at the centre of the entrepreneurial function.

The entrepreneur as defined by Cantillon is cloaked in non-

8. Nelson and Winter [1982] emphasise the imitator's difficulty in achieving economic success. For example, they state: "An imitator working with an extremely sparse set of clues about the imitatee's performance might as well adopt the more prestigious title of 'innovator', since most of the problem is really being solved independently. However, the knowledge that a problem <u>has</u> a solution does provide an incentive for persistance in efforts that might otherwise be abandoned." [p.124]

insurable, risk-taking garb. Quite simply, an entrepreneur buys at certain prices and sells at uncertain prices with the hope of realising a profit. Schumpeter [1954], seemingly ironically, pays tribute to Cantillon for having a "clear conception of the function of the entrepreneur" [p.222] because as he [1949] elsewhere states, "Cantillon emphasizes the elements of direction and speculation that certainly do enter into entrepreneurial activity". [p. 64] Cantillon [1755] stated:

> The Farmer is an undertaker (entrepreneur) who promises to pay to the Landowner, for his Farm or Land, a fixed sum of money (generally supposed to be equal in value to the third of the produce) without assurance of the profit he will derive from this enterprise. He employs part of the land to feed flocks, produce corn, wine, hay, etc. according to his judgement without being able to foresee which of these will pay best. The price of these products will depend partly on the weather, partly on the demand; if corn is abundant relative to consumption it will be dirt cheap, if there is scarcity it will be dear. Who can foresee the number of births and deaths of the people in a state in the course of the year? And yet the price of the Farmer's produce depends naturally upon these unforeseen circumstances, and consequently he conducts the enterprise of his farm at an uncertainty. [p. 49]

Cantillon's conception was, as Schumpeter [1954] suggests, "quite general, but he analysed it with care for the case of the farmer." [p,222] Schumpeter [1954] further states:

> Cantillon said indeed that the entrepreneur acquires means of production at certain prices with a view to selling at uncertain prices. This describes one of the businessman's activity very well, but it does not describe (or at any rate, emphasise) its essence [p.555n]

Schumpeter's statement should in no way be construed as a dilution of the significance of Cantillon's contribution. On the contrary, Schumpeter cites Cantillon's [1755] laudable Essai sur la Nature du Commerce en Général as "the first systematic attempt to work over the whole field of economics". Cantillon's contribution pro tanto was simply an embryonic one; viz., he recognised the entrepreneur and its central position in economic development, however generalised and unrefined.

The essence of the entrepreneurial function is what Schumpeter refers to as "carrying out new combinations", nothing more, nothing less. This strictest of definitions penetrates Cantillon's latency and calls forth a necessary distinction between the entrepreneurial and capitalist functions as is certainly evident with Cantillon's farmer. Schumpeter [1954] principally credits Say with this refinement whereby the entrepreneur is given "a definite position in the schema of the economic process". [p.555] However, Schumpeter does find fault with Say's refinement in that it fails to go far enough. Say's entrepreneurial function is merely "carrying out combinations" and not necessarily new combinations. Therefore, his formulation is relegated to an interpretation wherein the function can be carried out by a mere manager. As Schumpeter [1954] explains:

> His [Say's] contribution is summed up by the pithy statement that the entrepreneur's function is to combine the factors of production into a producing organism. Such a statement may indeed mean much or little. He certainly failed to make use of it and presumably did not see all its analytic possibilities. He did realise ... that a

> greatly improved theory of the economic progress might be derived by making the entrepreneur in the analytic schema what he is in capitalist reality, the pivot on which everything turned. But he failed to realise that the phrase 'combining factors' when applied to a going concern, denotes little more than routine management; and that the task of combining factors becomes a distinctive one only when applied not to the current administration of a going concern but to the organisation of a new one. In any case, however, he turned a popular notion into a scientific tool. [p.555]

While Say was providing a necessary distinction between the entrepreneur and the capitalist, he failed to abstract the managerial role from Cantillon's farmer. In effect, Say's conception unfortunately, but undeniably, tolerated the entrepreneur in a static as well as dynamic sense; viz., one can simply maintain operations _qua_ manager or administrator _and_ improve operations _qua_ entrepreneur or innovator and still be regarded as fulfilling the entrepreneurial function.

In Schumpeter's [1954] view, the damage was furthered by the younger Mill:

> J. S. Mill in analysing the entrepreneurial function, went from 'superintendence' to 'control' and even to 'direction' which he admitted, required 'often no ordinary skill'. But this defines the function of management and not anything distinct from mere administration. If this were all, he might as well have been content with the good English word for entrepreneur. A reason why he did not do so was possibly that managers are frequently salaried employees and they did not necessarily share in business risks, whereas J. S. Mill, like all the authors of that period and most of the authors of the next one, wished to make risk-bearing an entrepreneurial function alongside of 'direction'. But

> this only served to push the car still further on the wrong track. And there it stuck ... Say's suggestion came to very little. [pp.556-7]

In this extraordinary statement we gain a particularly valuable insight into the tendency to emphasise risk-bearing as the prime characteristic of the entrepreneurial function. In Mill's successful effort to bring the entrepreneur into general use among economists he also succeeded in vitiating the term. Mill [1848] stated that when capital is borrowed, "the lender ... is remunerated for it by the interest paid to him, while the difference between the interest and the gross profits remunerates the exertions and risks of the undertaker". [p.406] But, what if the entrepreneur fails and profits do not exist to cover interest payments and the principal, let alone his "exertions"? Moreover, what if the entrepreneur cannot fulfill the contractual obligations out of his personal wealth? With his attempt to extract the managerial function from Say's entrepreneur by adding risk-bearing, Mill, in effect, further entangled the capitalist function with the entrepreneurial function. Consequently, Mill's entrepreneur simply compounded and epitomised henceforth the confusion.

Finally, with Marshall, the confusion seems to come full circle. He insisted that if profits are treated simply as remuneration for risk (i.e., the remainder of gross profits once interest and management earnings have been deducted) then management activity is relegated or restricted to one of maintenance or administration. As Marshall [1910] asserted: "But this use of the term profits seems not on the whole advantageous, because it tends to class the work of management with mere routine attendance". [p.613] Ironically, perhaps, Schumpeter can nowhere be found to display such criticism as that levelled against Mill or Say. In fact, one can at best find criticism only of a gingerly sort that smacks of no less than praise. For example, in regard to Marshall's penetrating treatment of the scope of management earnings, Schumpeter [1954] remarked: "Marshall went further than most, however, in his careful analysis of earnings of management that expanded and deepened Mill's wages of superintendence so greatly as to make practically something new out of them". [pp.893-4] Schumpeter further stated that this was a "helpful suggestion" (and no more!).

Marshall treated the "work of management" in a very general manner to encompass all functions necessary to business. He [1910] wrote: "The work of management may be heavy because it involves great mental strain in organising and devising new methods; or because it involves great anxiety and risk; and these two things frequently go together". [p.612] Nevertheless his conception of the entrepreneurial function (though residing in the domain of management activity) was well depicted in his Principle of Substitution: "At the beginning of his undertaking, and at every successive stage, the alert business man strives to modify his arrangements as to obtain better (profitable) results with a given expenditure or equal results with a less expenditure" [Marshall, 1910, p.355]. Marshall's view, however, is not consonant with Schumpeter's in that he does not speak of entrepreneurship as being anything more than subtle modifications to ever-changing conditions.

Marshall is to be applauded for recognising and emphasising the differential ability in skills and performance between firms as a source of profits. Schumpeter holds Marshall in high esteem for establishing the necessity for awareness of behavioural or sociological aspects in economic theory. Leadership, for example, is an indispensable element in both their writings. As Schumpeter [1928], in defending his own work, remarked: " ... experience has taught [the well-trained economist] to think of such intrusions [viz. leadership] into theory of views savouring of sociology ..." [p.397n] He [1928] further stated: "no want of theoretical training is responsible for statements which I believe to tally fundamentally with Marshallian analysis". [p.379n]

Perhaps, Schumpeter preferred to overlook Marshall's neglect to distinguish the entrepreneurial function from the capitalist and management functions because of Marshall's generally known reservations concerning static analysis (though he did not make unsparing use of it in his <u>Principles</u>' footnotes). (Marshall's "biological" or "survival of the fittest" regard for economic growth is certainly in keeping with Schumpeter's viewpoint on Creative Destruction.) As Professor Loasby [1982] so delicately and apologetically noted:

> He [Marshall] does not make this distinction because he does not pursue very far the distinction between a stationary state and an evolving economy; and the reason for what he regards the formal analysis of a stationary state as a potentially misleading guide to the study of economic progress, which is the underlying concern in his <u>Principles</u>. [p.235]

Schumpeter, being a great admirer of Walras, did not share in Marshall's distaste for abstract or static analysis. Schumpeter

[1939], for example, asserts: "... the bare bones of economic logic ... render indispensable service in clearing the ground for rigorous analysis". [p. 68] Had Marshall been as flexible as Schumpeter, his treatment of the entrepreneurial function may have been less clouded in the Say-Mill tradition. As it stands, he offered no analytic insight.

Schumpeter, however, offers a solution which dismisses the confusion and ushers in an explicit distinction between the capitalist and entrepreneurial functions whilst keeping intact the distinction between the managerial function and entrepreneurial function. He does so by placing risk-bearing solely in the safe-keeping of the capitalist and not the entrepreneur. As Schumpeter [1934] logically argues: "Risk obviously always falls on the owner of the means of production or of the money-capital which was paid for them, hence never on the entrepreneur _as such_." [p. 75n] The entrepreneur simply bears no immediate or direct financial risk. To further quote Schumpeter [1954]:

> It should be obvious, so soon as we have realised that the entrepreneur's function is distinct from the capitalist's function, that an entrepreneur, when he employs his own capital in an unsuccessful enterprise loses as a capitalist and not as an entrepreneur. It has been said that if he borrows at a rixed rate of interest, the capitalist being entitled to repayment plus interest irrespective of results, it is the entrepreneur who bears the risk. But this is a typical instance of a very common confusion of economic and legal aspects. If the borrowing entrepreneur has no means of his own, it is obviously the lending capitalist who stands to lose, his legal rights notwithstanding. If the borrowing entrepreneur has means by which to effect discharge of his debt, he too is a

> capitalist and, in case of failure, the loss again falls upon him as a capitalist and not as an entrepreneur. [pp. 556-7n]

By confining or limiting risk to capital, Schumpeter provides a most vivid and clear distinction between the capitalist's function and the entrepreneur's function. In this restricted sense, Schumpeter is correct in proclaiming that risk-taking is in no way an element of the entrepreneur's function; viz, "the <u>direct</u> economic responsibility of failure never falls on him". [Schumpeter, 1954. p.137]

Certainly, Schumpeter's entrepreneur is a risk-taker, but in an <u>indirect</u> way. His very definition of the entrepreneur as being one who "carries out new combinations" is undeniably coloured with certain inordinate risk. Schumpeter [1939] is quick to concur, but with a requisite qualification:

> Risk, nevertheless, enters into the pattern in which entrepreneurs work. But it does so indirectly and at one remove; Riskiness - and every new thing is risky in a sense in which no routine action is - makes it more difficult to obtain the necessary capital and thus forms one of the instances of the environment which explain why innovations are not carried out smoothly and as a matter of course. [p.104n]

Schumpeter frequently recognises the indirect risk of the entrepreneur as that of "reputation". If an entrepreneur is unsuccessful with a particular venture, he obviously jeopardises his ability to persuade capitalists to finance future ventures. The magnitude of the failure, and the concomitant, future repercussions, are determined by the extent of the inability to fulfill the contractual arrangements established <u>ex ante</u> by the entrepreneur and investing capitalist. Indeed, in no way can he lose in the immediate or direct sense unless he too invested capital in his venture. But, then, he would also be acting in the capitalist capacity. Again, to call on Schumpeter [1934]:

> The one who gives credit comes to grief if the undertaking fails. For although any property possessed by the entrepreneur may be liable, yet such possession of wealth is not essential, even though advantageous. But even if the entrepreneur finances himself out of former profits or if he contributes the means of production belonging to his "static" business, the risk falls on him as capitalist or as possessor of goods, not as an entrepreneur. [p.137]

Perhaps Schumpeter's stirring statement, "the entrepreneur is never the risk bearer", is intended to mean simultaneously very much and very little. In attaining a proper distinction between the entrepreneur and the capitalist it means a great deal. Again, it is the capitalist who undertakes the immediate or direct financial risk of a venture. The entrepreneur, however, is simply responsible for innovation. The success in "carrying out new combinations" is undeniably a risk, but nevertheless an <u>indirect</u> risk of reputation. Entrepreneurial failure jeopardises acquisition of future capital. Thus, in this light, Schumpeter's statement <u>per</u> <u>se</u> comes to mean very little.

Within Schumpeter's argument that the entrepreneur is never the bearer or risk resides the condition or corollary that the entrepreneurial function is temporary. Innovation is simply by necessity an intermittent function of the businessman. As Schumpeter [1949] proclaims: "... it is difficult to imagine a case where a man does nothing but set up new combinations and where he does this all his life". [p. 66] It is one thing to set up a "new combination", but quite another to utilise innovation within the general scope of business success. Innovation, by definition, calls forth improvement and more precisely profits, but only if necessary and proper business conduct exists to implement it. Business conduct entails many activities besides entrepreneurship - i.e. administration, production, financial control, etc. Most of the literature on entrepreneurship neglects or assumes away such activities. Supposedly, the "routine ways" (those which fall under the all-encompassing function of management) of business take care of themselves.

Unfortunately, entrepreneurship is commonly considered synonymous with business success. It has often been said by scholar and layman alike: "One who does not succeed at business is a failed businessman, not an entrepreneur." In other words, success and not failure is attributed to the entrepreneur. Even Schumpeter, in his choice of words, skates dangerously near this implicit ceteris paribus assumption regarding other business activities. He [1934], for instance, states: " ... everyone is an entrepreneur only when he actually 'carries out new combinations', and loses that character as soon as he has built up his business, when he settles down to running it as other people run their business". [p. 78] Is the reader left to assume that because once one innovates, he ipso facto "builds up his business"? What if one does not "build up his business", does he remain an entrepreneur until he does so? The reasoning in the latter query seems logical, but would unlikely reflect Schumpeter's intention. The probable (though misleading) purpose of his statement was to show that "doing something new" was intended to increase profits, whether or not actually realised.

Naturally, it would be quite naive and mistaken to assume that entrepreneurship per se is responsible for business success. This statement may in turn be construed as: Without entrepreneurial activity, a business with all the other essential (though routine) activities will eventually succumb to competitive pressures and either be forced to innovate or lose its existence. The latter re-statement is more in keeping with the familiar Schumpeterian theme of Creative Destruction. Nonetheless, treating entrepreneurship as being solely responsible for business success or growth would be similar to performing Hamlet with only the Prince of Denmark. Surely, the play would prove inconsequential without, say, the ghost of Hamlet's father. And so it may be said, for example, of the management function and its part in effecting business success

Given the lengths to which Schumpeter goes to distance the entrepreneurial function from other functions of the businessman, he has sometimes been accused of neglect in his treatment of the management function. Hutchinson [1983], for example, stated: "It [Schumpeter's definition of the entrepreneurial function] is narrower in the sense that it excludes in practice many businessmen who fulfill a purely maintenance or control role". [p. 5] This statement smacks of the "second coming" of J. B. Say. Recognising (or even emphasising) other necessary activities of business need not, nor should, be at the expense of sacrificing necessary analytic distinctions. As Schumpeter [1934] succinctly explains: " ... the entrepreneur's essential function must always be mixed up with other kinds of activity, which as a rule must be more conspicuous than the essential one". [p. 77] Of course, Schumpeter is understandably leery of emphasising the merits of other business activities given his central concern of meticulously depicting the entrepreneurial function sui generis. Schumpeter [1934] quickly further states: "Hence the Marshallian definition of the entrepreneur, which simply treats the entrepreneurial function as management in its widest meaning, will naturally appeal to most of us. We do not accept it, simply because it does not bring out what we consider the salient point and the only one which specifically distinguishes entrepreneurial from other activities". [p. 77]

Perhaps much of the controversy regarding the use (or should we say abuse) of the concept would be extinguished if we stopped treating the entrepreneur as a physical person; alternatively, the focus should be on entrepreneurship, a unique business function that pervades all activities of business in a variety of degrees. After all, innovation like other business functions is performed invariably, however subtly, throughout a business organisation. Schumpeter [1934] concurs: " ... it is just as rare for anyone always to remain an entrepreneur throughout the decades of his active life as it is for a businessman never to have a moment in which he is an entrepreneur to however a modest extent". [p.78] Though Schumpeter is no exception to this sin of speaking of the entrepreneur as a physical person, he has rightly expressed the need for examining entrepreneurship as a distinct function, directly and indirectly within the scope of his emphasis on the "temporary" and frequently "humble" nature of "carrying out new combinations".

Conclusion

Schumpeter [1954] once remarked: "analytic progress - not only in economics - hinges in great part on making things explicit that have been implied or implicitly recognised for ages". [p,555n] However, Schumpeter's accomplishment was more than to clarify, refine, update and therefore make useful what had been said before; his analytical distinction between the entrepreneurial function and the capitalist and management functions serves to emphasise (though indirectly) the importance of all business activities in attaining profits and growth.

In an ever-changing competitive environment, business is continually forced to improve its competitive position. As is often said, "Business can either grow or decline, but it can never stand still". Improvement of course means effecting innovation as when, for example, a change in organisational structure brings about greater efficiency, an introduction of a different production process decreases costs, or the introduction of a new or improved product increases revenue. Innovation can (and should be expected to) come from all components of business, whether it be administration, production, or strategy and planning. Yes, the strategist may generally be more entrepreneurial than the administrator. But, the nature of entrepreneurship, as Schumpeter stressed, can often be "humble" and "temporary". Certainly, it is pervasive.

CHAPTER III

A Synthesis of Industrial Organisation and Business Strategy

Introduction

Industrial organisation and business strategy have long remained mutually exclusive in their use of analytical techniques, methodologies, and objectives in assessing competitive performance. The stark differences in approaches and purposes are fundamentally accounted for by the respective fields' practitioners. As Porter [1981] explained:

> The majority of economists studying industrial organisation and strategic management researchers have, over the years, mostly viewed each other with suspicion - if they knew each other existed. With few exceptions, industrial organisation had little effect on the business policy concept of strategy, and business policy had little effect on industrial organisation, despite the increasingly clear evidence that much promise for cross-fertilisation existed. Why these ships have passed in the night is an intriguing question. Some of the reasons reflect subtle, deep-rooted suspicions and even the type of training that scholars in both fields traditionally received. But many of the reasons reflect real underlying differences in the purposes, frame of reference, unit of analysis, and research values that each field has traditionally embraced. [p.609]

Within the past decade, however, significant advances in industrial organisation and business strategy have resulted from "cross-fertilisation".

The concern of business strategy is the study (normatively and descriptively) of the individual firm, its resources, capabilities, and values, and its environment. The emphasis of business strategy is on the intertwinement of competitive positioning, attaining long term objectives, and dynamics. According to Andrews [1971], for example: "Business strategy ... is the determination of how a company will compete in a given business and position itself among its competitors." [pp. 18-9] In other words, a firm's strategy, in establishing a particular competitive position, can only be revealed in view of the behaviour of competitors. Alternatively, Chandler [1962], for instance, places the emphasis of business strategy on seeking long term objectives. These goals dictate the courses of action pursued and the necessary allocation of resources. Finally, business strategy is also seen as a dynamic or ongoing process. For example, Cannon [1968] states: "Strategy is the catalyst, the main thread and thrust of the business. It is the dynamic element of managing which enables the company to achieve its results in the competitive marketplace over the long run." [p. 3]

Whilst business strategy is concerned with analysing the individual firm and its performance within an ever-changing environment, industrial organisation has traditionally focused only on industry as the unit of analysis and its performance. Moreover, industrial organisation has assumed a static or, at least, stable environment. Out of a desire to contribute to public policy-making, industrial organisation economists have centred their analysis on the direct relation between industry structure and industry performance, whilst disregarding the import of conduct (strategy) on performance. The argument has been since conduct was influenced by structure and could not, in turn, influence structure, conduct could be suppressed in any assessment of performance. (Contrary to business strategy, the human dimension played no role in industrial organisation.) A further limitation involved examining relatively few critical, structural elements, such as distribution of firm sizes (viz. concentration) and entry barriers.

The self-imposed limitations did not hinder, but actually encouraged, the statistical testing of structure/performance relationships in the quest for developing and improving competition policy. Where business strategy is concerned with improving a firm's performance from a private viewpoint, industrial organisation has been concerned with improving industry performance from a social viewpoint, which could actually mean reducing a firm's performance.

Fortunately, these general limitations in industrial organisation have been addressed by economists over the past ten years. The advances have included both empirical work and theoretical modelling to highlight the significance of intraindustry differences (viz. conduct) on performance, whilst not denying the influence of structural elements. A wealth of statistical investigations have given support to treating both the firm and industry as the unit of analysis. Significant modelling contributions have included "strategic groups", "mobility barriers", "competitive strategy", and "the value chain" (which are discussed in the chapter). Indeed, the long-awaited synthesis between industrial organisation and business strategy has well begun.

The Structure-Conduct-Performance Paradigm

The first and most seminal paradigm in the field of industrial organisation is attributed to Edward Mason and Joe Bain. Mason, in the wake of Chamberlin's [1933] The Theory of Monopolistic Competition, Robinson's [1933] The Economics of Imperfect Competition, and Berle and Means' [1932] The Modern Corporation and Private Property, pioneered what has become known as the structure-conduct-performance paradigm. Mason [1939] was very much concerned that the theorists of oligopoly in the 1930's were fundamentally mistaken because their "theoretical techniques of price analysis have been constructed without regard to their empirical applicability". [p.199] The inability of theoretical economists prompted Mason [1939] to state: "The theory of oligopoly has been aptly described as a ticket of admission to institutional economics. It is to be regretted that more theorists have not availed themselves of this privilege". [p.194]

The contributions of Chamberlin, his Harvard colleague, and Mrs. Robinson, provided Mason the positive impetus to approach the issue of price policy by emphasising the necessity of investigating the behavioural aspects of the firm. The theories of monopolistic and imperfect competition in Mason's [1957] words, "opened our eyes to the fact that firms typically have a scope of action with respect to prices and price structures, outputs and product mix, advertising and selling, investment, research, and other economic dimensions that require examination". [p. 4] In other words, Mason was emphasising the need to examine individual firms and their business strategies to fully understand the forces of competition in a capitalist economy. He quite agreed that we truly lived in Joan Robinson's "world of monopolies".

However, in order to test and measure statistically the performance of firms, Mason found it necessary to group firms into classes with generally the same type of market structure. And, in order to differentiate between a number of market structures, it was important only to consider a limited number of industry attributes deemed significant. With such a classification, Mason [1939] argued one could "reduce voluminous data concerning industrial organisation to some sort of order" which could therefore "explain through an examination of the structure of markets and the organisation of firms, differences in competitive practices including price, production, and investment policies". [p.195] Specifically, empirical studies noting differences in market structure could explain differences in policy and practice. Moreover, since conduct was directly determined by market structure, and market structure and conduct jointly determined performance, Mason was suggesting that performance was essentially determined by market structure. The influence of conduct on performance could therefore be ignored since it merely reflected the environment. By establishing a cause-effect relationship between structure and performance whereby the direction of causality was one way, the determinants of price policy could be ascertained. To ensure that performance could not notably affect structure, and therefore maintain the direction of causality, Mason[1939] appealed to a Schumpeterian theme of technological factors to account for differences in market structures. In effect, Mason signalled the genesis of the structure-conduct-performance paradigm. [See Figure 1][1]

Structure ⟶ Conduct ⟶ Performance

The Traditional Industrial Organisation Paradigm

<u>Figure 1</u>

The "structuralist" paradigm was primarily established by Mason's most distinguished student, Joe Bain. Bain's role and contribution was best described by Shepherd [1976]:

> In the 1930's Joe Bain entered a field which was in flux, rich in possibilities for giving new rigor to older concepts, for developing new ones, and for shaping the framework. That has been his main role and contribution. Though he did not create concepts, nor indeed the framework, he selected among them and carried their scientific analysis further than anyone else.... Like a Ulysses S. Grant, Bain hammered relentlessly at the basic problems. [pp. 4-5]

Like Mason, Bain argued that in order to analyse the market performance of business enterprise, an examination of market structures and market conduct needed to be undertaken. Bain [1968] believed that these two determinants were the main ones since "casual observation, common-sense, and formal theory" [p. 3]

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1. Mason stated: "I never completed this research for relations between structure and performance because it proved in the end too elusive and complex. But the study of the various elements that have to be taken into account in a study of market structures formed the basis of a series of articles and these by a whole series of students ... developing the relation of structure to behaviour to performance. The performance analysis tool went back into the antitrust field and I spent a considerable amount of time on the economic and legal characteristics of the monopoly problem." [Phillips and Stevenson, 1974, p.340]

suggested so. Performance (though broadly defined by Bain [1968]) refers to technical efficiency, allocative efficiency, and innovation. Conduct refers to the strategies or policies and practices undertaken by business enterprises taking into account such key variables as advertising, price, capacity and quality. Finally, structure refers primarily to number and size distribution of sellers and buyers and the condition of entry or height of barriers to new entry into a market. Sources of barriers to entry include generally: (1) product differentiation; (2) absolute cost advantages; and (3) economies of scale.[2] Of course, basic conditions are assumed to exist that influence market structure and conduct. On the supply side, for example, basic conditions include technology, accessibility to raw materials, product durability, etc. On the demand side, for example, basic conditions include price elasticity, substitutes, rate of growth, etc. Figure 2 illustrates (according to Scherer [1970]) the "structuralist" paradigm.

2. For examples of the various arguments for what constitute "barriers to entry", see Stigler [1968], Ferguson [1974], Fisher [1979], Weizsäcker [1980], and Demsetz [1982].

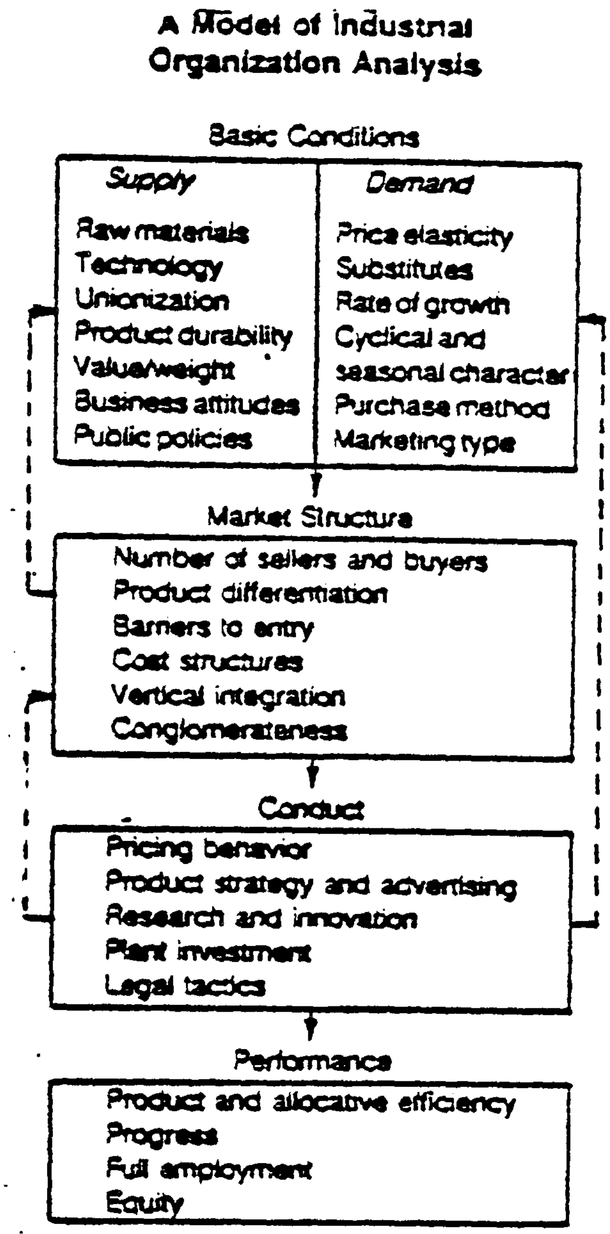

Figure 2

Moreover, Bain agreed with Mason that it was necessary to use a classificatory system whereby the number of market attributes were limited to a significant few. Otherwise, statistical testing would be inconsequential, if not impossible. Certainly, cross-sectional testing would not prove very meaningful, since the distinctiveness of different market structures would be eroded if too many market features were considered. As Bain [1970] proclaimed: "if one poured into market structure 'everything but the kitchen sink', we were left with an hypothesis irrefutable a priori and not subject to empirical test, because we were approaching the limit at which nearly every industry was in a very significant degree structurally unique, in a different 'class'". [p. 42]

Bain admitted that limiting the number of independent structural variables was not without its troubles. Indeed, some "statistical static" (viz. variance) would be expected. However, he believed this was a price worth paying in trying to confirm the central Masonian hypothesis where the relationship between structure and performance was deterministic.

Effective testing of the Masonian hypothesis critically depended on the components of market structure - viz. concentration and entry barriers - being reasonably stable or "comparatively immutable" over the long-run (i.e. "about ten years on average"). As Bain [1970] readily concurred: "If, afterall, attributes of market structure were will-o'-the-wisps that moved quite significantly with the tides or seasons, there would not be much left to test, except in some vary econometric context in which a number is just a number. Thus, we do need to inquire into comparative structural stability." [p. 44] Bain [1956; 1968; and 1970] found in his statistical studies that product differentiation proved to be the least stable of all structural variables primarily because of the nature of the consumer-good industries. (However, seller concentration along with conditions of entry were found to be "fairly stable over time".) Though his findings of some structural instability of "mutation" were cause for concern, Bain regarded the problem as "not destructive, but disturbing". Bain [1970] suggested that "in every case, compliment the selected measure of each mutable structural characteristic with a matching independent variable that denotes roughly the direction and degree of structural change over the period of the statistical test". [p. 46] Bain believed this statistical modification would assist in maintaining market structure "immutability" and therefore validate findings of the Masonian hypothesis.

In Bain's earlier years, he adopted Mason's original ideas regarding the influence of behavioural aspects (conduct) on performance. Bain [1944] stated:

> A considerable acquaintance with the population of sellers and buyers in a market, with the source of the materials and the character of their productive techniques, with the framework of law surrounding it is a prerequisite to the effective study of competition and price behaviour within the market. This is true for both the author and the reader. The merits of such an analysis should not be confined, however, to its service as a preface to further work. A description, from the vantage point of economic analysis, of the environment of a principal industrial market may prove useful and perhaps illuminating to the economist and the general reader alike. It may further acquaintance with the extremely complex character of business institutions in the modern world, and may suggest hypotheses for investigation in the immediate or other industries. [p. vii]

But, like Mason, Bain chose instead to de-emphasise the influence of conduct on performance. In fact, Bain concluded that conduct provided a "poor basis for predicting market performance". Specifically, in industries where varying degrees of interseller co-ordination existed, tremendous variation in pricing aims were observed which naturally resulted in diverse performance consequences. Bain, however, agreed that an investigation of individual firms would reveal a deterministic relationship between conduct and performance. But, of course, he was concerned with examining market performance. Consequently, though conduct is an important linkage a priori in the structure-conduct-performance triad (as will be discussed later), it was essentially "unascertained" empirically. Conduct merely reflected the environment. As Bain [1968] explained:

> But as we try through empirical investigation to implement or verify this sort of explanatory-predictive hypothesis, we find that actual patterns of market conduct cannot be fully enough measured to permit us to establish empirically a meaningful association either between market conduct and performance, or between structure and market conduct. It this becomes expedient to test directly for net associations of market structure to market performance, leaving the detailed character of the implied linkage of conduct substantially unascertained [p.329]

Elsewhere, Bain [1968] asserted with equal conviction: "The particular choice of the device for ordering nonindependent seller action is relatively inconsequential and perhaps haphazard, since any of the devices, in a particular structural setting, can lead to roughly comparable performance results". [p.331] It is of little wonder that Bain [1968] devoted only one chapter (out of sixteen) to market conduct in his "basic textbook", Industrial Organisation.

The profound impact of Bain's commitment (among other ecnomists his work influenced[3]) to "structuralism" was to provide a basis for formulating government antitrust and regulatory policy (i.e. examining the effects of seller concentration and entry barriers on industry competition as measured by profitability). More important, perhaps, Bain had given the field of industrial organisation a lasting scientific foundation. Specifically, in the words of Shepherd [1976], "he had given it structure, precision, and high standards of research quality" [p. 16], from which future research would be precipitated.

<u>The Gulf Between Industrial Organization and Business Strategy</u>

The seminal work of Bain and his followers have, in effect, isolated a gulf between industrial organisation and the field of business strategy, which offers a wealth of theoretical and empirical investigations. The suggestion, therefore, is that industrial organisation needs to make an important transition. As Teece [1984] succinctly stated: "The principal focus becomes not one of how to increase consumer welfare by enhancing competition but rather how to increase profits (and, if necessary, reduce consumer welfare) by containing or restricting competition." [p. 94] Elsewhere, Porter [1981] explained: "public policymakers could use their knowledge of the sources of entry barriers to lower them, whereas business strategists could use theirs to raise barriers, within the rules set by anti-trust policy".[p.612] Clearly, this fundamental philosophical difference between

3. See Weiss [1972; 1974] and Scherer [1970] for a comprehensive review of "structuralist" contributions.

industrial organisation and business strategy has rested on the unit of analysis - i.e. the firm v. the industry.

Originally, Mason and Bain believed in the analysis of the firm (as discussed earlier) as principally important in understanding competition and price policy. Both, of course, changed their minds and decided that industry should be the unit of analysis if any significant contribution was to be made in the formulation of public policy. But, examining the industry as a whole implied treating the individual firms as homogenous entities or "empty boxes" that only differed economically in terms of size and market share. Consequently, conduct was not considered to alter appreciably from one firm to the next. And, since it was directly dictated by market structure (which was assumed not to change "over the long run") conduct was deemed inconsequential in assessing market performance. The Bain/Mason paradigm was essentially static in nature. Contrarily, business strategy had focused on the individual firm and its organisational structure being unique vis-a-vis other firms within an industry. As is readily observed, differences in firms and their levels of profitability do exist and must be accounted for somehow. In other words, analysing conduct or strategy is important (if not often crucial) in ascertaining a firm's performance and its possible feed-back effects on conduct and market structure.

Over the past fifteen years, the industrial organisation literature has given a great deal of attention to what has become known as the conduct v. structure debate. As Newman [1978] asserted: "We question whether an analysis of conduct patterns and their direct determinants is either the empirical redundancy of the statistical quagmire that it has been commonly portrayed." [p.425] Though structural elements are still considered meaningful as underlying determinants of conduct and performance, intra-industry differences (which infers conduct discrepancies) have become recognised as a credible influence that must be reckoned with in any realistic and therefore accurate assessment of industry competition.[4] A number of studies have been fostered by this viewpoint whereby both firms and industries have been examined. Findings by Osborn [1970], Demsetz [1973], and Round [1975] have shown that small firms' performance as measured by their levels of profit is better in unconcentrated industries than concentrated industries. Stonebraker [1976] in his industry studies found a simultaneous existence of large firms with high profit rates and small firms with eratic and generally low profit returns. Shepherd [1970] and Gale [1972] argued that market power is firm-specific and primarily dependent on the firm's own market share, whereby the level of profits are consistent with size. However, Shepherd further argued that entry barriers "appear to have only a relatively small role in market structure..." [p. 35] Marcus [1969], alternatively found in a study of 118 industries that the relationship between firm size and profitability to be mixed, if not dubious. While 35 industries exhibited a positive relationship, 9 revealed a negative

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4. Phillips and Stevenson [1974] pointed out that Adam Smith in The Wealth of Nations "saw not only the affects of market structure and conduct on performance but also the endogenous effects of conduct and performance upon market structure." [p.325]

relationship, and 74 showed no significant relationship at all. Finally, Porter [1979] pointed out a co-existence of profitability being related to market power and leading firms not necessarily being the most profitable. Clearly, the sample of empirical studies cited purport the existence and significance of dynamic intraindustry (interfirm) differences, whilst (in most cases) maintaining the importance of static structural determinants.

Evidence of the significance of interfirm differences on performance highlights the heterogeneity or segmentation of industries and differences in firms' capabilities and strategic choices. Interfirm differences and their impact on the competitive environment can be greatly explained by the "strategic groups" model [Newman, 1978; and Porter, 1976; 1980] and "mobility barriers" [Caves and Porter, 1977; and Porter, 1980]. Essentially, the existence or relevance of strategic groups is founded on the premise that "market structure has an affinity for differentiated oligopoly" [Caves, 1980, p. 66]. Because firms sell different products in response to heterogeneous buyers' preferences and possess durable firm-specific assets, they undertake variegated strategies and differences in rates of return therefore result. Consequently, firms that undertake similar strategies are assumed to be members of the same strategic group. An industry could have only one strategic group whereby all firms would follow essentially the same strategy. Also, it is possible for every firm in an industry to be a separate stategic group.

The question that asserts itself regarding the concept of strategic groups is that of industry boundaries. It might appear that all that is taking place is to reduce a redefinition of a homogenous set of sellers from an industry to a group. Porter [1976], however, stressed that this is not the case:

> First, although I suppose that oligopolistic interdependence is recognized more fully within groups than between them, I also suppose that it is recognized more fully by firms in the same industry than by firms in different industries. The industry becomes segmented but does not disappear. Second, groups may be distinguished from one another because their products are imperfect substitutes, but that is not necessary. Groups can be differentiated by factors that affect the conditions of sale of a good but not the good itself (such as the width of the product line of which it is a part or the manufacturer's policy toward the retail stage), or by factors (such as vertical integration) that differentiate the product not at all in the eyes of the customer. [p. 77]

Where strategy variations exist in industries, an industry contains a set of strategy groups which Porter [1976] termed as "group structure". Group structure is an important concept because it "affects rivalry by making mutual dependence asymmetrically recognised within industries." Where firms have similar strategies and differ in terms of, say, absolute cost, then there is a recognised mutual dependence related to only absolute cost. Mutual dependence is more clearly evident among firms in the same strategic group than between groups. Firms having recognised other firms within the same strategic group are likely to predict and react to these firms' actions in an effective manner since their common strategy reflects similar subjective and objective attributes. Consequently, co-ordination of actions are more likely to be attained within strategic groups than across groups.

Multiple strategic groups within an industry usually translate into rivalry implicati-ons [Porter, 1980, Ch 7]. Generally, the greater number of strategic groups within an industry, the greater the degree of rivalry because of the implied increased asymmetry among firms. Porter [1980] cites four factors which determine the strength of interaction between strategic groups; (1) the degree to which different strategic groups compete in different market segments; (2) the degree of product differentiation; (3) the number and size (i.e. market share) of strategic groups; and (4) strategic difference or the extent to which strategies diverge. [pp. 138-139] All four determinants combined dictate the pattern of rivalry.

Mobility barriers serve a useful and natural purpose within the strategic group model. Essentially, they act to generalise entry barriers by further encompassing exit barriers and movements between strategic groups. The determination of mobility barriers is partly exogenous (structural) and party endogenous (strategic). The merit of mobility barriers is <u>not</u> to refute Bain's [1954] rigorous treatment of entry barriers, but to <u>extend</u> it whereby the "mobility" of firms can be considered. As Caves and Porter [1977] stated:

> The theory of entry barriers, concentrating on the movement of a firm from zero output to some positive output, has missed a great opportunity for generality. Entrants into an industry can be entirely new firms or firms already established elsewhere. Firms may enter one or another segment of a given industry, and firms already operating in one segment may shift to another. [p.249]

Within the traditional framework entry barriers serve to protect all firms in an industry in the same way from external competition, whereas mobility barriers serve to protect firms from other firms in different strategic groups within the industry as well as firms outside the industry ("dual protection"). The structural aspects of barriers between groups are the same as those between any group and firms outside the industry. For any individual group the queue of potential entrants includes firms from other strategic groups, established firms in other industries, and entirely new firms. Generally, going firms (whether inside or outside an industry) would be expected to be the principal entrants into an industry "core", whereas new firms would seek to enter the competitive fringe.[5]

Conventional entry barrier analysis also assumes that the queue of potential entrants is simply ranked by the rate of return each expects to earn given a recognised limit price which measures the height of entry barriers. The situation is merely "them and us". However, when examining mobility barriers, several queues of potential entrants are considered because of the recognised diverse capabilities and strategic objectives of incumbents.

Absent within the Bain tradition is consideration for the process by which firms would enter an industry. To quote Caves and Porter [1977]: "Conventional entry theory has the unsatisfactory property of positing that the firm chooses to enter at the same scale x in the industry, and that this choice is independent of its future plans". [p.255] However, in the presence of strategic groups and mobility barriers, because several paths

5. Important antecedents of this argument are Andrews [1964] and Hines [1957].

exist for a risk-averse, potential entrant, several alternative strategies would be considered. Entrance into an "optimal" group may well require taking a circuitous route via other groups where barriers are more easily surmounted. If the potential entrant is unsuccessful, it will have probably lost less than if it had directly attempted to break into the ultimately desired group where the height of barriers was higher. The underlying assumption is that groups with the higher barriers offer the highest return for the successful challenger over the long run. The sequence of moves for the challenger is likely to be contingent on the incumbents' irreversibility of investments (exit barriers) and capacities and experience accumulated along the way which allow it to reach a position to successfully mount an assault on the "optimum" group.

The irreversibility of investments refers to the concept, "committed competition", which Caves [1984] defined as "rivalrous moves among incumbent producers that are irrevocable for non-trivial periods of time". [p.127] The extent of committed competition is measured by the salvage value of abandoned resource commitments. Caves and Porter [1977] asserted that the more intangible the nature of investments, the lower the salvage value, and therefore the greater the actual commitment. Intangible assets (e.g. goodwill, knowledge), acquired through expenditures on advertising and research and development, for example, are perhaps the most significant barriers to entry in that they serve as the extreme forms of differentiation and excess capacity.

Expenditures on intangible assets are generally referred to as "sunk costs" to the extent they are non-recoverable.[6] Such investments can consequently act as significant obstacles to entry, particularly given the incumbent has first-mover advantage [Johns, 1962; Salop, 1979]. Eaton and Lipsey [1981] refer to capital investment that is irrecoverable as must being "product specific". Otherwise, if past expenditure on capital can be recovered, it can be used in the production of other products. Elsewhere, Geroski and Jacquemin [1984] treat committed competition by examining what they call "differential movement advantage", whereby an incumbent can limit the range of alternatives available to a potential challenger given its investments that cannot easily be matched. Schelling [1960], perhaps, best captured the thrust of an incumbent's behaviour, when he remarked: "the essence of their tactics is some voluntary but irreversible sacrifice of freedom of choice. They rest on the paradox that the power to constrain an adversary may depend on the power to bind oneself". [p. 22]

The strategic group model (encompassing mobility barriers), in essence, serves to identify firms' strengths and weaknesses and therefore explains differences in profitability of firms within the same industry. The structural elements and concepts within the Mason/Bain framework can indeed be generalised by way of strategic groups and mobility barriers to substantially increase

6. The significant work of Baumol, Panzar, and Willig [1982] and Sharkey [1982] regarding "contestable markets" and "natural monopoly" have rigorously propounded that sunk costs, rather than fixed costs, account for entry barriers or committed competition. They cite the air transport and communication industries as evidence.

one's knowledge of the forces of competition that have been extracted from business strategy. Caves [1980], for example, stated that the concepts of strategic groups and mobility barriers were "a dynamised add-on to the traditional structure-conduct-performance paradigm." Porter [1983] went further and declared: "This theory (i.e. the strategic group model) addresses the underlying causes of differences and attractiveness among different strategic positions within an industry, bringing structural analysis down to the level of the firm".[p.177] And, furthermore, "strategy research [should] start with the premise that competitive patterns differ from industry to industry, and where competitors are recognised as central and are viewed as living organisations with particular personalities, strengths and weaknesses". [p.179] However, the strategic group model is incomplete because it does not account for all of the competitive forces. It only serves to address existing rivals and potential entrants, with no consideration for the bargaining leverage of buyers and suppliers and the threat of substitute products and services. Without knowledge of these other forces, any understanding of firms' strategic behaviour and industry competitiveness or profitability can only be partial and therefore, perhaps, misleading.

Michael Porter [1980] in his important book Competitive Strategy, has redressed this deficiency in the strategic group model by incorporating the "competitors" - buyers, suppliers and substitutes (along with existing rivals and potential entrants) - into a competitive strategy framework. Porter refers to this broader scope of competition as "extended rivalry" [See Figure 3 taken from Porter, 1980, p. 4]

Forces Driving Industry Competition

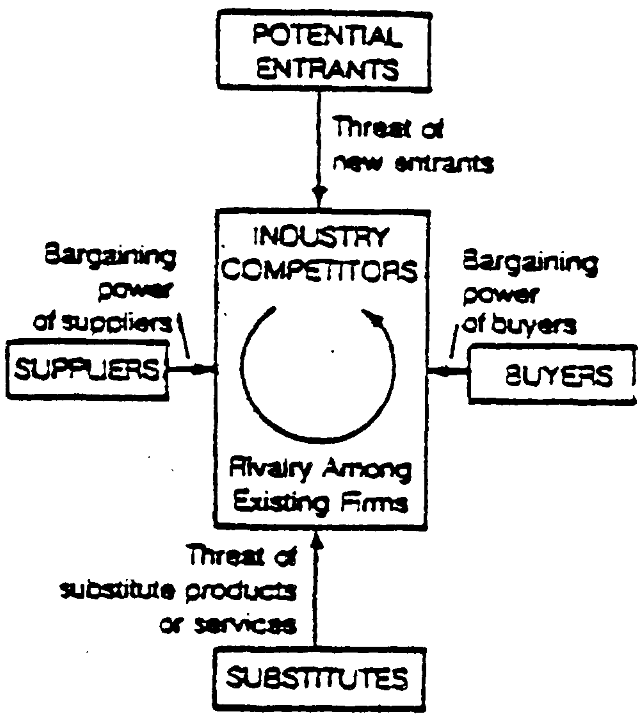


Figure 3

Once these "structural" determinants of the intensity of competition have been analysed and the underlying causes identified, a firm should be able to accurately assess its strengths and weaknesses. Only then, can a firm effectively devise a competitive strategy which would enable it to position itself in an industry so that its capabilities can best influence and defend against the existing array of competitive forces. The effectiveness of a firm's competitive strategy and consequent market positioning is, of course, reflected in its performance vis-a-vis that of rival firms.

Porter [1980] identified three generic strategies a firm can choose from to attain above-average performance in any industry: overall cost leadership, differentiation, and focus. A firm undertaking a cost leadership strategy seeks to become the low-cost producer (without sacrifice to quality and service) in the industry. The sources of cost advantage include, for example, scale economies, low-cost labour, going down the learning curve, preferential access to raw materials, and tight overhead control. A cost leadership strategy generally requires a firm to hold a large share of the market. Only then can, say, economies of scale be fully realised. Having a low-cost position provides a firm protection from competitors, because its lower costs assure above-average industry returns in the event of price reductions. A low cost firm will be defended against buyers because buyers will only exert pressure on the next most efficient firm. Also the low-cost firm will maintain greater flexibility regarding increases by suppliers on input prices. Scale economies and/or absolute cost advantages act as barriers to potential entrants. Finally, employing a low-cost strategy reduces the threat of substitutes.

The second strategy is concerned with a firm differentiating a product or service to the extent it is considered unique in the industry. Therefore, large market share is unlikely to be a realistic objective given the emphasis on seeking exclusivity. The essence of this strategy regarding the competitive forces is that differentiation creates brand loyalty and goodwill, and therefore effects price insensitivity or inelasticity which mitigates the power of existing rivals, potential entrants, buyers, suppliers, and substitutes.

The last strategy is concerned with focusing on an industry subset such as a certain buyer group, geographic market, or product segment. Focus strategy differs from low-cost and differentiation strategies by being directed at a particular industry target rather than the industry as a whole. Serving an industry target is based on providing either low-cost, differentiation, or a combination of the two more effectively than any other firm. Because the strategy is very specialised, the focus firm will not likely enjoy a large market share. The relationship between the three strategies is illustrated in Figure 4 [as taken from Porter, 1980, p. 39].

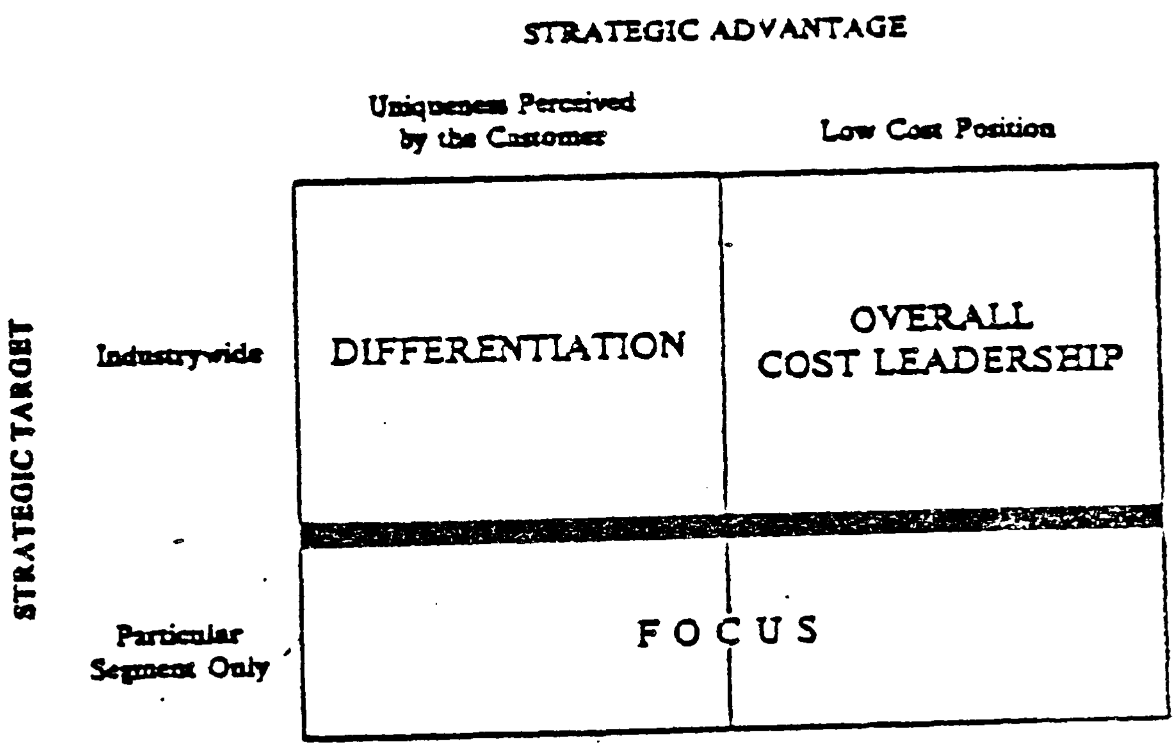


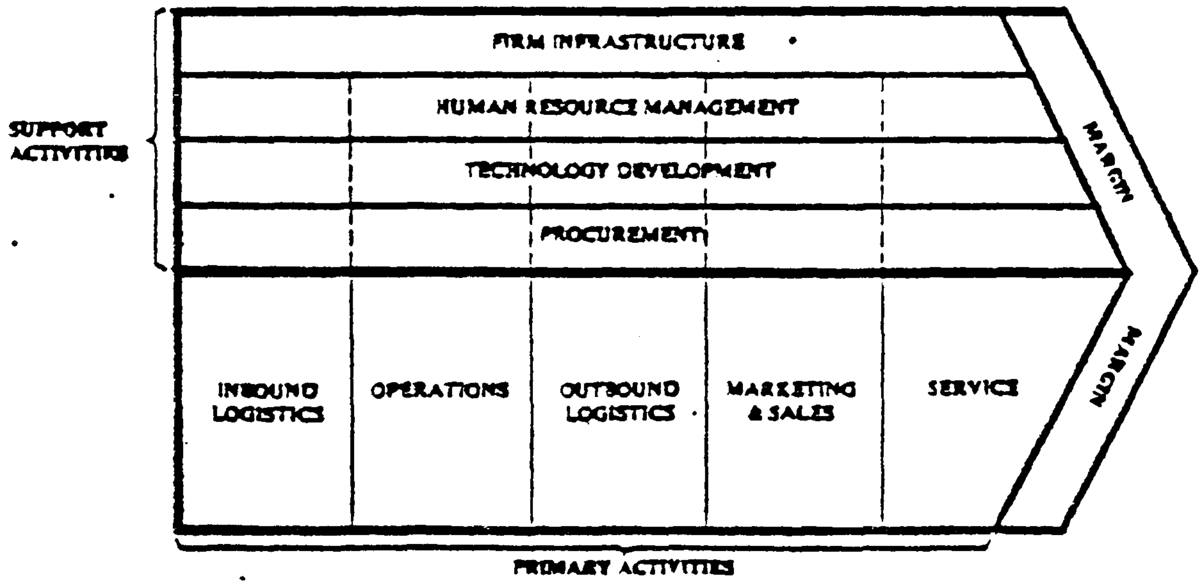
Figure 4

Competitive strategy, as stated by Porter [1980]:

> presents a comprehensive framework of analytical techniques to help a firm analyse its industry as a whole and predict the industry's future evolution, to understand its competitors and its own position, and to translate this analysis into a competitive strategy for a particular business. The underpinning of this framework is the analysis of the five competitive forces acting on an industry and their strategic implications. [p.xiv]

Indeed, as Teece [1984] suggests, competitive strategy is "a translation, redirection, and refinement of the Mason/Bain structure-conduct-performance paradigm ..." [p. 94] Moreover, it has provided the fundamental link between industrial organisation and business strategy.

Porter's [1985] latest contribution, Competitive Advantage has gone beyond Competitive Strategy. Competitive Advantage introduces the "value chain" as an analytical tool by which firms can choose and implement the appropriate competitive strategy and therefore create and sustain high performance. Value chain analysis is a systematic method of disaggregating all the strategically important activities a firm undertakes. [See Figure 5] By isolating such activities, the manager or strategic analyst can better understand the behaviour of costs and the existing and potential sources of differentiation. Creating value for its customers is the essence of achieving competitive advantage. Value may be in the form of prices lower than a firm's competitors for the same benefits or differentiated products that create benefits that more than offset premium prices. Quite simply, differences in competitor value chains are the source of competitive advantage.



The Generic Value Chain

Figure 5

Value activities are divided into two general categories, primary activities and support activities. Primary activities are grouped into five categories: (1) inbound logistics; (2) operations; (3) outbound logistics; (4) marketing and sales; and (5) service. Inbound logistics are those activities concerned with receiving, storing and disseminating inputs to the product. Operations are those activities that convert inputs into finished products. Outbound logistics are those activities associated with collecting, storing, and distributing the product to customers. Marketing and sales concerns those activities connected with providing the means by which customers buy the product and are persuaded to do so. Finally, service involves those activities that enhance or maintain the value of the product.

Support activities support the primary activities and each other. These activities include procurement, technology development, human resource management, and firm infrastructure.

Procurement refers to the purchase of inputs not directly associated with the product and may be purchased anywhere in the firm's value chain. Technology development activities are concerned generally with the improvement of the product. Human resource management involves those activities concerning the hiring, training, and motivation of personnel. Finally, firm infrastructure refers to those activities (e.g. accounting, finance, legal) that might be considered "overhead".

Some or all of the primary and support activities may apply to a particular firm, depending on the make-up of the firm and its industry. All of a firm's activities are assigned a place within the value chain with regard to their economics, impact on cost, and potential benefit to differentiation. In other words, categorizing activities is made in accordance with their contributions to a firm's competitive advantage. The systematic and integrative approach of value chain analysis allows for all possible sources of competitive advantage to be examined.

Conclusion

The synthesis of industrial organisation and business strategy has been primarily due to the efforts of economists studying industrial organisation. In recent years, such economists have done so because they have shown, in the words of Teece and Winter [1984], "greater diversity and flexibility of theoretical approach, and particularly a greater willingness to trade off some of the aesthetic advantages of simplified models against the virtue of a greater contact with a complex reality." [p.120]

It has been argued that scholars of business strategy have failed to contribute to the synthesis because of not being well-equipped by their backgrounds. Caves [1980], for example, asserts:

> If one accepts the weak postulate that the firm is a purposive organisation maximising some objective function, it follows that its strategic and structural choice represents a constrained maximisation problem. My reading is that students of business organisation with disciplinary bases outside of economics would accept that proposition but have lacked the tools to follow its blueprint. Constrained maximisation problems are mother's milk to the well-trained economist. [p. 88]

However, both economists and business scholars can make further offerings in the form of empirical investigations. The recent pioneering work of Porter, in particular, has provided a necessary theoretical foundation for examining directly the process by which a firm establishes its competitive advantage. Clearly, empirical contributions must naturally follow if the synthesis of industrial organisation and business strategy is to continue its progress. As Leontief [1971] made quite plain: "True advance can be achieved only through an interative process in which improved theoretical formulation raises new empirical questions and the answers to these questions, in turn, lead to new theoretical insights." [p. 5]

CHAPTER IV

The Methods of Investigation and Sample

Introduction

The research had its beginning in December 1983 when Dr. Gavin C. Reid, my supervisor, introduced me to Professor Peter Grinyer of St. Andrews University. Professor Grinyer spoke enthusiastically about empirical research yet to be undertaken (to his knowledge) regarding the inception and growth of small (i.e. owner-managed) firms by way of enterprise trusts[1] in Scotland. He suggested that in order to acquire access to enterprise trusts, the proper channel would be Mr. Graham Ross,

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1. Enterprise trusts are a relatively new phenomenon in Britain (the first being established in England in 1978) created jointly by the private sector and (usually local) government authorities in an effort to promote economic welfare in particular communities plagued with high unemployment. Specifically, enterprise trusts seek to assist new and existing businesses in their particular areas by providing advice, writing business plans, finding premises, and, in some cases, offering financial support. What is unique about enterprise trusts is the commitment by private industry. Most of the personnel of an enterprise trust are on secondment from sponsoring, private sector firms. The secondees are usually experienced managers or specialists who plan to stay with the trust for a period of time ranging from a few months to several years. Almost invariably only large corporations can afford such secondments. Often times, secondments are used for the management development of employees in mid-career, but there is also a significant number who are highly experienced senior managers approaching retirement. This begs the question of whether relatively sophisticated, corporate managers could really understand and relate to the independent entrepreneur or small businessman. However, given that the principles of business apply to all enterprises no matter what the size, age, or type, experienced managers from corporate enterprises would therefore seem to be ideal sources of advice.

Director of Scottish Business in the Community (Scot BIC).[2] Professor Grinyer kindly agreed to write a letter of introduction to Mr. Ross on my behalf.

Within a fortnight of meeting Professor Grinyer, I met Mr. Ross and discussed the merits of my proposed research and emphasised the lack of research undertaken at the university level regarding the small firm sector in the economy. It was impressed on Mr. Ross the need to meet a number of enterprise trust directors in order to obtain effective access to new small firms and actually spend a period of time with an enterprise trust. The experience of being in residence with an enterprise trust would allow me the opportunity to gain first-hand knowledge of new small firms and their market environments. Consequently, the acquired insight would fundamentally influence the construction of the methods of investigation (viz. the Finance Section in the administered questionnaire) and assist in the analysis of the data.

<u>Unstructured Design Work</u>

In January 1984 I met Mr. Douglas Martyn, Chief Executive of Ardrossan, Saltcoats, and Stevenston Enterprise Trust, Ltd., (ASSET). Given that ASSET was the first and largest enterprise trust in Scotland, I thought a wealth of insight and experience could be gained by being associated with ASSET for an extended period of time. However, if I was to be in residence with

2. Scottish Business in the Community (Scot BIC) is an entity sponsored by corporate business for the purpose of setting-up enterprise trusts in Scotland.

ASSET, I would be expected to actively participate in a contributory way. I stressed that I could act in a consultant's capacity with respect to the "after start-up care" given my academic training in finance, management and economics. Because ASSET was primarily involved with starting-up new businesses and helping established companies expand into the ASSET area, little time remained for ASSET to effectively satisfy the consultancy needs of up-and-running firms. After making two more visits to ASSET to meet other members of staff, I was offered a consultant's position. It was mutually decided that 10 weeks (21 May - 27 July 1984) would be an adequate period of time for both ASSET and myself to sufficiently benefit. In return for my being able to observe ASSET's operations and meet businesses who had received assistance from ASSET, I was expected to give a series of seminars to businesses on such matters as cash flow accounting, inventory control, and marketing and visit individual firms to help resolve their particular problems. This latter responsibility ranged from discussing market strategy, to costing, to finding market surveys and reports, to simply acting as a "sounding board".

During my first two weeks with ASSET, most of the time was spent familiarising myself with the project officers' functions, being introduced to a number of businesses, and taking notes from the files in order to acquaint myself with the ASSET-supported enterprises. The files were divided into four sections: Initial Enquiries, Live Projects (i.e. firms in the process of starting-up or expanding), Completed Projects, and Dead Projects (i.e. firms that had failed to get started or went into liquidation). In examining the Initial Enquiries, I found a wide variety of business proposals. Moreover, the great majority of individuals seeking to start their own businesses were doing so as merely an alternative to unemployment. In other words, people were primarily being "pushed", rather than "pulled", into entrepreneurship. In fact, out of 141 Initial Enquiries, 112 expressed that unemployment, redundancy, or anticipating redundancy were primarily responsible for pursuing self-employment. Finally, nearly every Initial Enquiry indicated a need for financial assistance.

The Live Projects included business plans for individuals seeking finance either to set-up in business or expand their present operations. The business plans were written by an accounting firm hired by ASSET. The plans provide the history of the business under consideration (usually in the case of expansion of "phoenix" operations), background of proposers, assistance needed (generally finance and/or premises), proposed funding structure, market potential, and pro forma financial statements. What was particularly interesting of the 25 business plans examined, in 21 cases the "gearing" (leverage) ratio exceeded one. And, in may of these cases, the external finance (viz. debt) came from a variety of sources. Sources of finance included banks, the Scottish Development Agency, regional and local government authorities, the British Steel Corporation, and ASSET. Business ventures that seem viable and show promise in creating employment usually receive ASSET's support even in cases where the business proposers cannot match pound for pound the external finance. ASSET firmly believes that without bringing together what would truly be risk capital, most of the ventures they have assisted would not have got "off the ground" or at the very least would have been greatly handicapped by inadequate finance. As they rightly expressed, the undoing of any business venture is undercapitalisation from the start. And, with its highly qualified and respected staff,[3] ASSET is able to attract capital which businesses could probably not be able to do on their own. Banks, in particular, are more willing to lend to ASSET-supported businesses because they know ASSET has properly scrutinised the proposed venture in advance. Banks are actually quite grateful to ASSET for acting as a "screen". Moreover, because ASSET has funds of its own to invest (up to £5000/firm) and can appeal to a consortium of public and private institutions for capital finance, there is a greater likelihood for businesses to acquire the necessary finance in a relatively short period of time.[4]

Much time was spent assisting in the preparation for Enterprise Week (17th - 23rd June 1984). Enterprise Week involved the official opening of the Ardrossan Small Business Centre by Mr. David Trippier, Under-Secretary of State for Trade and Industry, Open Day at the Stevenston Industrial Estate, and seminars

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3. Mr. Stewart McArthur has been particularly valuable in this regard as a member of ASSET because of his influence in the banking community. He is a banker of long experience and is a former Assistant General Manager of the Clydesdale Bank.

4. ASSET is rather unique with respect to other enterprise trusts in Scotland in that it does have funds to invest in business ventures, as well as premises to let.

on "How to Start Your Own Business". One of my responsibilities was to telephone all the enterprise trusts in Scotland to inquire about what they were doing for Enterprise Week. This activity proved to be very helpful to the research in that it gave me the opportunity to introduce myself and explain the objectives of the research. In the conversations, directors expressed enthusiasm for a meeting and at the very least a willingness to provide introductions to firms in their area. Consequently, visits were made to some of the enterprise trusts which ultimately led to the establishment of the sample.

Given the length of time spent with ASSET, my responsibilities, and the number of businesses and concerned individuals met, I believe proper consideration for the problems and concerns confronting new small firms was established, which was the major objective of this phase of the research. More specifically, with respect to the survey work to follow, much inaccuracy and superficial knowledge would be avoided because of having played an interactive role with research participants as they went about their ordinary activities in their natural habitat.[5] In short, it was paramount to observe and participate in real-life situations in order to effectively and honestly analyse them. This approach would continue in the collecting of the data.

The Administered Questionnaire

The administered questionnaire (AQ) was conducted by Dr.

5. This argument is supported in Burgess [1984]

Reid and myself amongst 73 firms during April - October 1985. The AQ is divided into 5 sections: (1) General; (2) Pricing; (3) Costing; (4) Sales and Competition; and (5) Finance. The General section seeks information regarding a firm's industrial classification, number of employees, sales revenue, main product group, principal market, market share, number of competitors, and characteristics of customers. The Pricing section is concerned with such factors as price determination and the affects of a boom and recession on pricing decisions. The Costing section investigates, for example, capacity level, fixed and variable costs, and changes in output. The Sales and Competition section looks at, for instance, price changes (5 and 10 percent) under varying business conditions, reasons for altering selling price, and forms of competition from rival firms. Finally, the Finance section examines such matters as obstacles to obtaining finance, security, "gearing" (leverage) ratios, cash flow difficulties, and expansion plans. [See Appendix 3]

The design of the AQ was accomplished by Dr. Reid. The categories and content of the first four sections were inspired by Reid [1981] and Nowotny and Walther [1978]. The formulation of the categories and content of the Finance section is essentially credited to the influence of my experience with ASSET (as discussed earlier) and my academic training in finance and accounting.

After a number of redrafts, the AQ was tested in a "pilot" study of 13 firms in February - March 1985. The primary benefit derived from the "pilot" was the actual experience of conducting the AQ. Specifically, attaining consistency in defining terminology and clarifying intentions of questions resulted. Many of the 13 firms expressed concern that the AQ was "big business" and "manufacturing" oriented. Consequently, much of the wording was altered or "softened" so that the AQ would appeal to all business enterprises irrespective of size or type. Also, it was quickly realised in the "pilot" that the AQ should be conducted in a reasonably relaxed and "open-ended" manner. In other words, the interviewee was not discouraged to elaborate (and to some extent digress) on his responses, if he so desired. It was appreciated that the interviewee regarded the interview as an opportunity to share some of his concerns with someone whom he considered genuinely interested in the welfare of his business and something of an expert. In many instances, the interviewer was asked to give advice or at least share his thoughts on particular aspects of the firm's conduct and performance. Allowance for discussion greatly served to influence the formulation of the second stage of the research - i.e. the semi-structured interview.

Finally, the Finance and Costing sections were the most cumbersome part of the interview. The "gearing" ratio questions, for example, often required careful elaboration. Many of the firms indicated they left such financial matters with their accountant. Questions regarding borrowing and security, in particular, were often times considered sensitive issues by the interviewee and consequently had to be treated with some degree of delicacy by the interviewer to insure honesty in responses. Because of the inter-relationship of the Finance questions, the interviewer could easily identify inconsistencies in responses. However, much tact was necessary in pressing the interviewee to rectify his inconsistencies. With respect to the Costing section, a number of firms expressed difficulty conceptualising a static cost function that depicted their overall cost structure. Specifically, many firms wanted to treat expenditure on fixed assets as variable costs in examining the change in total output with changing total costs. Also, many firms were more comfortable dealing with fixed and variable costs, rather than marginal costs. They knew what marginal costs were but often times it was admittedly a difficult figure to calculate.

Arranging to see each firm involved a letter of introduction followed by a telephone call. The letter opened by noting the importance of the small firm sector to the economy and pointing out that little research from the university level had been undertaken "which could help promote awareness for further support" of small business. The letter proceeded to explain the purpose of the research. It was emphasised that it is important to acquire knowledge of firms' conduct first-hand in order to provide an accurate and meaningful assessment of what could be done to promote the inception and growth of small firms. After asking for an hour of time to go through the AQ, it was stated that the firm could immediately benefit from the objective exercise in that they would "perhaps learn (or at least be reminded) ... about the conduct of their business and its effectiveness ..." Also, it was mentioned that a summary of results from the study would be sent to them if they so desired. Finally, the letter suggested that the firm contact the mentioned enterprise trust director, who had provided the firm's name and address, to inquire about the research further as well as Dr. Reid and myself. [See Appendix 1]

A few days after sending the letter of introduction, the firm's owner-manager was given a telephone call with the intention of arranging a meeting. After stating who I was, the owner-manager was asked if he had received my letter. And, if so, did he have any questions regarding the letter's content. Once these questions (if any) were addressed, the owner-manager was asked when it would be convenient to go through the AQ (assuming he was interested). It was stressed that it was important to try and meet within a week and at a venue and time which was mutually agreeable. I indicated that I was prepared to see him during or after working hours and at his office or home; it was made quite clear that time and place did not have to be a problem.

Upon arrival, and after the normal exchange of pleasantries, I usually spoke briefly about the purpose of the research as a reminder. Second, I stressed that this was an academic project and not one being conducted for an enterprise trust, the Scottish Development Agency, or some other governmental body. In fact, I often noted that the research was being principally funded by Edinburgh University and the Scottish Economic Society, an independent, academic organisation. Third, the interviewee was told that his name or the firm's name would not be mentioned in the findings; confidentiality would be upheld as promised in the letter. Fourth, it was stated there were no right or wrong answers; the research was not prescriptive, but rather descriptive, in its approach. Finally, the interviewee was told that if he did not understand any of the questions, he should feel free to ask for clarification. The objectives in the preliminary conversation were to dismiss any uncertainty or apprehension the interviewee might have about the AQ and/or myself and establish a comfortable (if not informal) rapport in what was inherently a formal situation. By recognising that the interviewee is human, has his own set of personal characteristics and interests, and has never met the interviewer before, it was necessary to try and put the relationship on a personal basis quickly to create a positive atmosphere whereby the interview could proceed smoothly with unnecessary formality. Keeping the interview on an abstract business level would have likely inhibited the quality and candour of the information given.

Prior to leaving the interview, I restated that a summary of results would be sent in due course and thanked the owner-manager for his time. A thank-you letter was sent within a week of each interview; there was the conscious effort to not only create goodwill with all participants, but also maintain it.

The Semi-Structured Interview

The semi-structured interview (SSI) [See Appendix 4] was conducted by Dr. Reid and myself in July-October 1985 amongst 24 firms (counting 7 in the "pilot") that participated in the AQ stage. The intention of the SSI was to go beyond the AQ and delve into the conduct of firms to create and sustain competitive advantage in the market. The SSI contains three distinct sections: (1) Competitive Forces; (2) Competitive Strategy; and (3) Defensive Strategy. (This framework was adopted from Porter [1980 and 1985] as discussed in Chapter III). Each section consists of a series of probes/agenda items to effectively direct the course of the interview. After the interview was concluded, the interviewer would record any additional notes, observations, and impressions that were not recorded during the interview. This was to be done as soon as possible once the interview was finished whilst it was fresh in the mind of the interviewer. Then the interviewer would type a summary note for each of the components of the SSI's sections. Finally, the summary notes were stored in the data base in the computer along with the AQ information.

Dr. Reid was responsible for the design of the SSI as well as the procedures by which it was conducted. The SSI was greatly influenced by the previous stages in the research and Porter [1980 and 1985]. In particular, the SSI allowed for points to be pursued that were raised during the course of the AQ stage. Porter's influence was that of a casework orientation and an appeal to fieldwork methodology. Moreover, the SSI adopted Porter's framework and made it operational.

Similar to the AQ stage, the primary benefit gained from undertaking a "pilot" for the SSI was interview experience and enhanced familiarity and consistency with the content and use of the terminology. Because the SSI was discussion-oriented, the interviews were found to average 90 minutes in duration, rather than the expected 60 minutes. Once the "pilot" was concluded, Dr. Reid and I were satisfied with the probes/agenda items and decided against any revision of the SSI.

The SSI was particularly successful because the firms found the exercise to be significantly relevant and beneficial to their operations. By first examining the 5 competitive forces - i.e., existing rivals, potential rivals, suppliers, buyers, and substitute products/services - that exist for all businesses in all industries, the firms could objectively assess their strengths and weaknesses. Once this was accomplished, they could assuredly determine the appropriate strategy - i.e. low cost, differentiation, or focus - to implement in order to effectively compete in their industry. Many times firms pleasantly realised they did not have to worry about direct confrontation with larger rivals by pursuing a focus strategy that concentrated on a particular market niche. The final section was not always relevant, particularly with newer firms since they were still creating or finding, rather than defending, a market niche. However, discussion on defensive strategy often revealed certain considerations and tactics firms would eventually confront.

The firms that participated in the SSI stage did so because of their expressed interest at the time of their AQ interview; i.e. they saw the <u>quid pro quo</u> as being fee consultancy service. Though the research was entirely academic, it was quite clear that in order to get ports of entry, firms had to be approached on their own terms. In doing so, it was understood that some firms perform well whilst others do not. Consequently, it was imperative in seeking further access to firms not to suggest that the SSI would be judgmental in spite of it being directly relevant to assessing firms' strengths and weaknesses and effectively formulating the right business strategy. Unfortunately, more firms agreed to undertake the SSI than time and financial constraints of the research allowed. Otherwise, the sample frame of the SSI would have been much larger. Therefore, those firms that were selected were done so because of their uniqueness vis-a-vis other interested firms; it was important to have examined a highly diverse set of firms.

The Sample

The sample consists of 73 small firms from the Lothian, Fife, and Strathclyde regions. The sampling procedure used was judgmental or non-probabilistic. The Edinburgh Venture Enterprise Trust, Ltd. (EVENT), the Leith Enterprise Trust, Ltd (LET), the Glenrothes Enterprise Trust, Ltd (GET), the Irvine Development Corporation (IDC), and the Scottish Development Agency (SDA) provided names, addresses, and telephone numbers of firms to contact.[6] It was emphasised to these organisations that I did not want to approach any firm that would not want to be involved in the research. Otherwise, reference could have been made to telephone directories and/or industrial indexes which would probably have meant a much lower response rate. Establishing the sample by this means would have been a more time-consuming and expensive activity. However, gaining access to

6. Four firms in the sample were contacted because of personal referral.

firms through the above mentioned organisations proved to be a quite effective and efficient method in that 86 out of 104 firms contacted actually participated either in the "pilots" or the study proper. The response rate of 83 percent was particularly gratifying given that many other similar studies' response rates were typically less than 60 percent.[7] It could be considered disadvantageous to undertake this type of judgmental sampling because it might be biased towards successful firms. After all, it seems plausible that such firms would be more likely to participate than those that are simply trying to survive. However, many of the sample firms were in fact found to be struggling and looked at participation in the research as an opportunity to objectively analyse and perhaps assist in solving their problems. Also, because the sample firms are generally regarded as new in that only 4 firms have been in existence for more than 10 years, firms were still very much trying to establish their market niche. Consequently, involvement in the research was often regarded as a means of seeking advice. Moreover, many of the firms that did not wish to participate in the research were relatively large and expressed that because they were satisfied with their conduct and performance, there was little, if anything, to be gained from involvement in the research.

Other kinds of possible biases, aside from the involvement of only successful firms, may act to distort the quality of the data. For example, many firms in the sample were controlled

7. The most notable studies include Boswell [1972] with a 60 per cent response rate and the Research Reports which accompanied the Bolton Committee Report [1971] with response rates of 30, 40 and 50 percent.

by more than one owner-manager, with potentially varied expertise (e.g. production, finance and marketing), experience and perceptions of the firm's conduct and even performance. Fortunately, only in a few cases did all of a firm's owner-managers not participate in the research. Also, it is possible that the perceptions of the owner-manager(s) may vary from that of other firm-related individuals such as employees and financiers. Employees, for instance, might consider themselves as indispensable inputs, whereas the owner-manager(s) might consider the possible substitution of capital goods (e.g. automated machinery) for labour. This possible fundamental difference in attitudes may account for altered perceptions of the conduct of the firm. Providers of external finance may also have a different perception of a firm's operations because of their central concern of recovering their invested funds. The suggestion is that perhaps <u>all</u> individuals involved with a particular firm should participate in the research in order to acquire a more accurate appraisal of the firm's conduct and performance. However, it should be stated that the intention of the research was to examine the owner-managers' perceptions and how they acted on these perceptions. Finally, the owner-managers' possible concern with trying to please the interviewer by giving the "right answers" would be a source of bias. However, this bias is believed to be negligible given that it was always stressed by the interviewer that there were no right or wrong answers; the research was intended to be expositive, rather than critical of the firms' operations.

The significance of potential biases in the research has been much relaxed because of the "slices of data" approach taken and the incorporation of "consistency checks" in the administered questionnaire. As stated by Reid [1986]* a "slices of data" approach refers to "using diverse methods of collecting data, with the purpose being to get different perspectives on categories, or emerging hypotheses." [p. 8] The methods undertaken in the research include: (1) unstructured design work; (2) an administered questionnaire; and (3) a semi-structured interview. The merit of taking "slices of data" according to Reid [1986] is that it "tends to offset the bias of methods, and balance the misrepresentations of respondents against one another". [p.8] Also, a number of "consistency checks" were utilised in the Administered Questionnaire to ensure consistency in responses and accuracy. For example, the owner-manager was asked whether he borrowed money to start his business. Later, he was asked about his initial "gearing" ratio. If, for instance, a negative response is given to borrowing money, zero should be the "gearing" ratio. Otherwise, the owner-manager(s) would be asked to explain the discrepancy.

The sample firms are quite diverse in that 29 classes from the 1980 Standard Industrial Classification (SIC) are represented. [See Table 1] Though many firms indicated that more than one

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*See G.C. Reid [1986] Methodological and Empirical Issues in the Application of Field Research Techniques to the Business Enterprise. Discussion Paper I, Economics Department, University of Edinburgh.

class was applicable to the scope of their operations, they chose the class that defined their main business. In other words, more than 29 classes could have been noted. Unfortunately, no official statistics exist to give some idea of how representative the sample is of its universe. The essential problem is that the Business Statistics Office does not collect census information from business establishments employing fewer than 20 persons. This is indeed problematic given that only 11 firms from the sample employ 20 or more persons; this figure represents only 15 percent of the sample. Moreover, the most recent census data regarding the number of business establishments in Britain was published in 1982.[8] Out of the sample of 73 firms, 54 firms (i.e. 74 percent of the sample) did not exist 4 years ago. However, the wide cross-section of firms in the sample may provide some insight or indication of the new small firm population in Scotland.[9]

With respect to the type of business, all firms except one are either a one-man business (i.e. sole trader), a partnership, or a private (i.e. limited liability) company. [See Table 3] The exception is a cooperative, which is defined as being largely owned and managed by all those working in it. No public companies are included in the sample. Though 35 firms, 48

8. See Business Monitor PA1002 Report on the Census of Production, 1982, HMSO.

9. In support, Binks and Coyne [1983] stated: "small firms are found in most sectors of the UK economy. Contrary to what might be expected, there is no evidence that they are concentrated in service industries; they provide high proportions of employment in both manufacturing and construction." [p. 22]

percent of the sample, are private companies, where technically ownership is divorced from management because such a company is a separate legal entity, all the firms' owners or shareholders and the managers or directors are one and the same. That is, in every case, every individual that holds an equity stake is directly involved in the firm's decision-making process. Forming a limited company was done with the intentions of taking advantage of lower tax rates, limiting owners' liability, and enhancing the firms credibility or image with their customers and competitors. Many firms that are either one-man businesses or partnerships indicated that they did not think they could generate enough profits to take advantage of lower tax rates applicable for private companies and justify the £800 registration fee. Another consideration was that if a firm could not generate a sufficient level of profit as a limited liability company, it would be taxed at a higher rate than if it were a sole trader or partnership.

As indicated in Table 2, the great majority of the firms started at a modest size in terms of total assets (book value). The average size was £17,200 with £130,000 being the largest individual figure. Also, it is important to note that 58 firms had total assets of £50,000 or less when they started operations. This figure represents 89 percent of the firms that stated starting total assets. In examining present total assets, the average rose by £65,000 to £83,000 with the largest figure being £500,000. Nonetheless, there were still 44 firms with total assets of £50,000 or less. The figure represents 66 percent of the firms that stated present total assets. If one considers the number of firms that started with less than £100,000 in total assets, 63 firms - i.e. 97 percent of the sample that provided this figure - would fall into this category. However, in terms of present total assets, 52 firms - i.e. 78 percent of the sample that provided this figure - have less than £100,000. In other words, whereas only 2 firms stated they started with £100,000 or more in total assets, 15 firms indicated that in terms of present total assets they have at least £100,000. In 9 instances, firms failed to give the amount of their starting and/or present total assets because of either simply not knowing or an expression of confidentiality.

Looking at the most recent fiscal year's sales revenue of the firms provides yet another insight into the firms' size of operations. As shown in Table 4, a large majority of firms that provided sales figures (49 firms or 86 percent of the sample), had sales revenue of £300,000 or less with a significant proportion (29 firms or 51 percent of the sample), showing no more than £100,000. The reason 15 of the 16 firms did not provide sales figures was that they had not yet been in business for a full year. Given their size of present total assets and change in starting and present total assets, it would appear that no more than 2 firms would exceed £100,000 of sales revenue in their first year of operation. If this were the case, 59 percent, rather than 51 percent, of the sample had no more than £100,000 in sales revenue for the past year. The remaining unaccounted firm did not wish to comment on sales. Of the 8 firms that had turnover exceeding £400,000, 4 had sales revenue between £1,000,000 and £2,000,000 and 4 noted that sales revenue was less than £1,000,000.

In examining the employment figures in Table 5, it can be seen again that the firms are essentially small and likely owner-managed. The average size of the sample's work force (including full-time and part-time employees and trainees) is nearly 11 employees. Only 3 firms have more than 50 employees with the largest figure being 89. And, the firm with 89 employees, only 50 of these are full-time. Most importantly, 49 firms have 10 or less total employees and 69 firms - i.e. 95 percent of the sample - have 30 or less total employees. In many instances, firms expressed concern for keeping the level of employment at an absolute minimum out of fear of having to lay-off employees if an unexpected drop in demand occurred. Also, there was an expressed preference or need to be capital-intensive. Both factors were seen to contribute to maintaining stable employment levels and therefore insuring good labour relations.

Finally, the firms' market share of their main market, in view of the firms' recent sales figures, partially highlights their degree of industry influence. Usually, there is a positive relationship between size of firms and market power. Table 6 shows that the sample is essentially one of either small market shares of small markets, small market shares of large markets, or large market shares of small markets. In other words, as supported by the sales figures, firms are small in that they exert relatively minimal market influence. For firms 2, 3, 4, 8, 12, 16 and 18 where there appears to be a large share of a large market, their main product group appeals to a narrow market segment because of uniqueness, lack of demand, or being too technologically advanced.

TABLE 1

INDUSTRIAL CLASSIFICATION OF THE SAMPLE

Classes *	Number of Firms
Production and distribution of electricity, gas and other forms of energy	1
Metal manufacturing	1
Manufacture of other metal goods	2
Mechanical engineering	4
Electrical and electronic engineering	7
Manufacture of motor vehicles and parts	1
Instrument engineering	1
Food, drink and tobacco manufacturing	3
Textile industry	3
Footwear and clothing industries	2
Timber and wooden furniture industries	4
Manufacture of paper and paper products; printing and publishing	4
Processing of rubber and plastics	1
Other manufacturing industries	8
Construction	4
Wholesale distribution	3
Commission agents	1
Retail distribution	3
Hotels and catering	1
Repair of consumer goods and vehicles	1
Other inland transport	1
Air transport	1
Supporting services to transport	2
Business services	5
Renting of movables	1
Owning and dealing in real estate	1
Medical and other health services	1
Other services provided to the general public	4
Recreational services and other cultural services	2
Total:	73

* Classes taken from 1980 Standard Industrial Classification (SIC).

TABLE. 2:

FIRM	STARTMO	STARTYR	SASSET	PASSET	SALES
1	********	84	16000	16000	£0 - £50,000
2	8	82	70000	105000	OVER £400,000
3	6	83	5000	4000	£0 - £50,000
4	********	83	20000	60000	£100,001 - £150,000
5	11	83	1500	7000	£0 - £50,000
6	9	83	65000	88000	£250,001 - £300,000
7	********	66	1000	90000	£100,001 - £150,000
8	9	84	0	100000	********************
9	10	84	5000	9000	********************
10	7	84	10000	30000	£100,001 - £150,000
11	********	82	130000	130000	OVER £400,000
12	********	76	70000	500000	OVER £400,000
13	1	84	4000	15000	£0 - £50,000
14	4	84	1500	1200	£0 - £50,000
15	12	84	16000	65000	£200,001 - £250,000
16	********	75	10	50000	£50,001 - £100,000
17	12	83	5000	100000	£200,001 - £250,000
18	6	84	10000	40000	£0 - £50,000
19	7	84	35000	55000	£200,001 - £250,000
20	3	84	3500	5000	£0 - £50,000
21	5	84	8000	32000	£0 - £50,000
22	********	75	2000	100000	£150,001 - £200,000
23	5	84	16000	25000	£50,001 - £100,000
24	2	84	0	4000	£0 - £50,000
25	5	84	2500	20000	£0 - £50,000
26	2	85	2000	4000	********************
27	1	85	1000	1000	********************
28	9	83	3000	50000	£100,001 - £150,000
29	2	85	20000	20000	********************
30	4	84	8000	27000	£50,001 - £100,000
31	8	83	6000	0	********************
32	9	84	35000	35000	********************
33	10	84	14000	40000	********************
34	3	84	5000	50000	£150,001 - £200,000
35	4	74	22000	350000	OVER £400,000
36	********	77	10900	415000	£150,001 - £200,000
37	********	82	3500	8500	£0 - £50,000
38	********	77	15000	15000	£50,001 - £100,000
39	1	82	18500	72000	£150,001 - £200,000
40	********	75	1000	30000	£50,001 - £100,000
41	3	83	100000	100000	£250,001 - £300,000
42	9	79	1000	50000	£100,001 - £150,000
43	2	85	17000	17000	********************
44	6	80	35000	350000	OVER £400,000
45	10	84	600	12000	********************
46	7	83	2000	5000	£0 - £50,000
47	********	82	2000	30000	£0 - £50,000
48	9	76	175	900000	OVER £400,000
49	11	80	0	0	£50,001 - £100,000
50	********	76	600	30000	£50,001 - £100,000
51	11	81	60000	95000	OVER £400,000
52	10	83	15000	50000	£50,001 - £100,000
53	9	83	3000	10000	£0 - £50,000
54	3	83	2	180000	£200,001 - £250,000
55	1	85	12000	20000	********************
56	8	84	0	0	£100,001 - £150,000
57	9	84	10000	300000	********************
58	11	84	7000	9000	********************
59	********	84	8000	25000	********************
60	********	82	1000	30000	£0 - £50,000
61	2	85	0	7000	£0 - £50,000
62	********	80	0	0	£250,001 - £300,000
63	9	84	3000	150000	£50,001 - £100,000
64	********	78	5000	70000	£50,001 - £100,000
65	2	85	20000	25000	********************
66	********	73	200	50000	£150,001 - £200,000
67	6	83	22000	22000	£100,001 - £150,000
68	11	84	16000	14000	********************
69	********	83	8000	20000	£0 - £50,000
70	********	61	0	0	£50,001 - £100,000
71	********	81	0	0	OVER £400,000
72	11	84	12000	34000	£0 - £50,000
73	4	83	95000	200000	£250,001 - £300,000

SYMBOLS:
STARTMO - month business started
STARTYR - year business started
SASSET - total assets of business when started
PASSET - total assets of business at present
SALES - last fiscal year's sales revenue
******** - not given
0 - total assets not given

TABLE 3

TYPE OF BUSINESS

Type		Number of Firms
One-man business		22
Partnership		15
Private company		35
Public company		0
Other		1
	Total	73

TABLE 4

SALES LEVELS*

Sales		Number of Firms
£0 - £50,000		18
£50,001 - £100,000		11
£100,001 - £150,000		7
£150,001 - £200,000		5
£200,001 - £250,000		4
£250,001 - £300,000		4
£300,001 - £350,000		0
£350,001 - £400,000		0
Over £400,000		8
	Total	57

* Firms were asked to give their last fiscal year's sales figure excluding VAT.

		PTNO	TRAINNO	TOTAL
1	2	********	0	2
2	11	2	2	15
3	1	1	0	2
4	16	1	4	21
5	5	1	0	6
6	12	2	1	15
7	5	********	0	5
8	3	3	1	7
9	2	********	0	2
10	6	********	0	6
11	47	3	0	50
12	50	35	4	89
13	1	2	0	3
14	1	********	0	1
15	8	5	0	13
16	4	1	0	5
17	15	********	0	15
18	2	2	0	4
19	16	3	0	19
20	1	********	0	1
21	1	1	1	3
22	4	********	0	4
23	4	2	0	6
24	2	********	1	3
25	5	********	0	5
26	1	********	0	1
27	1	********	0	1
28	9	********	1	10
29	1	1	0	2
30	2	********	0	2
31	1	********	0	1
32	1	2	0	3
33	4	********	1	5
34	27	1	0	28
35	25	2	1	28
36	50	********	3	53
37	1	1	0	2
38	2	4	0	6
39	11	1	1	13
40	7	6	1	14
41	10	1	0	11
42	7	1	1	9
43	2	1	0	3
44	52	2	3	57
45	9	2	3	14
46	2	3	2	7
47	2	2	0	4
48	20	1	0	21
49	5	********	1	6
50	7	1	1	9
51	18	********	2	20
52	3	********	0	3
53	2	1	0	3
54	5	2	0	7
55	5	1	2	8
56	3	3	0	6
57	5	5	1	11
58	2	********	0	2
59	3	1	0	44
60	1	1	1	3
61	4	********	0	4
62	3	********	0	3
63	3	2	2	7
64	5	********	0	5
65	3	3	0	6
66	9	2	4	15
67	5	7	0	12
68	1	1	0	2
69	2	1	0	3
70	3	4	0	7
71	18	1	0	19
72	2	5	0	7
73	21	1	2	24
Total	595	133	47	775
Average	8.15	1.82	.64	10.61
Percentage	76.8%	17.2%	6.0%	100%

SYMBOLS:
EMPLOY - full-time employees
PTNO - part-time employees
TRAINNO - trainees
~~********~~ - 0

TABLE 6:

FIRM	MMKT	SHARE	SALES
1	REGION	UNDER 1%	£0 - £50,000
2	INTL. ECONOMY	11-20%	OVER £400,000
3	SCOTLAND	31-50%	£0 - £50,000
4	U.K.	11-20%	£100,001 - £150,000
5	INTL. ECONOMY	UNDER 1%	£0 - £50,000
6	REGION	1-5%	£250,001 - £300,000
7	REGION	UNDER 1%	£100,001 - £150,000
8	U.K.	OVER 50%	*******************
9	REGION	UNDER 1%	*******************
10	SCOTLAND	UNDER 1%	£100,001 - £150,000
11	REGION	1-5%	OVER £400,000
12	INTL. ECONOMY	21-30%	OVER £400,000
13	SCOTLAND	1-5%	£0 - £50,000
14	REGION	OVER 50%	£0 - £50,000
15	REGION	OVER 50%	£200,001 - £250,000
16	U.K.	OVER 50%	£50,001 - £100,000
17	INTL. ECONOMY	UNDER 1%	£200,001 - £250,000
18	SCOTLAND	OVER 50%	£0 - £50,000
19	SCOTLAND	1-5%	£200,001 - £250,000
20	LOCAL COMMUNITY	*******************	£0 - £50,000
21	REGION	*******************	£0 - £50,000
22	U.K.	UNDER 1%	£150,001 - £200,000
23	SCOTLAND	*******************	£50,001 - £100,000
24	REGION	11-20%	£0 - £50,000
25	SCOTLAND	UNDER 1%	£0 - £50,000
26	SCOTLAND	1-5%	*******************
27	SCOTLAND	1-5%	*******************
28	SCOTLAND	31-50%	£100,001 - £150,000
29	SCOTLAND	31-50%	*******************
30	REGION	31-50%	£50,001 - £100,000
31	REGION	UNDER 1%	*******************
32	INTL. ECONOMY	*******************	*******************
33	SCOTLAND	UNDER 1%	*******************
34	U.K.	1-5%	£150,001 - £200,000
35	U.K.	UNDER 1%	OVER £400,000
36	INTL. ECONOMY	UNDER 1%	£150,001 - £200,000
37	SCOTLAND	UNDER 1%	£0 - £50,000
38	U.K.	6-10%	£50,001 - £100,000
39	REGION	*******************	£150,001 - £200,000
40	REGION	UNDER 1%	£50,001 - £100,000
41	LOCAL COMMUNITY	OVER 50%	£250,001 - £300,000
42	REGION	21-30%	£100,001 - £150,000
43	SCOTLAND	UNDER 1%	*******************
44	REGION	1-5%	OVER £400,000
45	LOCAL COMMUNITY	UNDER 1%	*******************
46	INTL. ECONOMY	UNDER 1%	£0 - £50,000
47	LOCAL COMMUNITY	11-20%	£0 - £50,000
48	SCOTLAND	*******************	OVER £400,000
49	LOCAL COMMUNITY	UNDER 1%	£50,001 - £100,000
50	SCOTLAND	UNDER 1%	£50,001 - £100,000
51	U.K.	11-20%	OVER £400,000
52	SCOTLAND	1-5%	£50,001 - £100,000
53	SCOTLAND	*******************	£0 - £50,000
54	SCOTLAND	11-20%	£200,001 - £250,000
55	SCOTLAND	*******************	*******************
56	REGION	6-10%	£100,001 - £150,000
57	SCOTLAND	UNDER 1%	*******************
58	LOCAL COMMUNITY	*******************	*******************
59	REGION	OVER 50%	*******************
60	LOCAL COMMUNITY	OVER 50%	£0 - £50,000
61	SCOTLAND	21-30%	£0 - £50,000
62	LOCAL COMMUNITY	UNDER 1%	£250,001 - £300,000
63	INTL. ECONOMY	11-20%	£50,001 - £100,000
64	U.K.	*******************	£50,001 - £100,000
65	LOCAL COMMUNITY	*******************	*******************
66	LOCAL COMMUNITY	31-50%	£150,001 - £200,000
67	LOCAL COMMUNITY	*******************	£100,001 - £150,000
68	LOCAL COMMUNITY	*******************	*******************
69	REGION	*******************	£0 - £50,000
70	LOCAL COMMUNITY	11-20%	£50,001 - £100,000
71	LOCAL COMMUNITY	*******************	OVER £400,000
72	SCOTLAND	1-5%	£0 - £50,000
73	LOCAL COMMUNITY	*******************	£250,001 - £300,000

SYMBOLS:

MMKT - main market

SHARE - percentage share of main market

SALES - last fiscal year's sales revenue

******************* - not known

Final Remark

The primary objective set forth at the outset of this research project was to establish a data base, rich in both quantitative and qualitative information. Once the fieldwork was completed, the obtained data was mounted on the computer using the Scientific Informational Retrieval (SIR) package for the purpose of analysis and storage. SIR is unique with respect to other computer packages in that it is able to handle not only the numeric information of the administered questionnaire, but also the textual information of the semi-structured interview. It is expected that in time further information from the data base will be gleaned for other academic projects.

CHAPTER V

Competitive Strategy: Some Evidence

Introduction

The formulation and implementation of competitive strategy in pursuit of competitive advantage is inextricably related to entrepreneurship. The dynamic process of strategic choice or (using Schumpeter's phrase) "carrying out new combinations" is fundamental to any business enterprise that intends to survive and develop. Conditions in a firm's environment are always changing and require either proactive or reactive adjustment on the part of the firm.

In this Chapter, evidence from the semi-structured interviews conducted amongst 17 firms from the sample is examined. As discussed in Chapter IV, the semi-structured interview adopts Porter's [1980 and 1985] framework in assessing how a firm actually interprets its market and industry and the consequent impact that interpretation has on moulding its competitive strategy. The first section analyses the competitive forces - i.e. rivalry (existing and potential), customers, suppliers, and substitutes - that influence, if not determine, the generic competitive strategy firms undertake. The second section looks at the generic competitive strategies - i.e. low cost, differentiation, and focus - and how they are implemented and sustained. Using Porter's "value chain" analysis (as discussed in Chapter III) is a valuable means by which to systematically assess the activities a firm performs in designing, producing, marketing, and distributing its products and services. Competitive advantage is ultimately derived from these activities. Finally, the third section considers the defensive strategies firms pursue in order to sustain competitive advantage in their chosen market niches. Specifically, increasing barriers to entry, increasing retaliation which challengers can expect, lowering the inducement for attack, using industry senarios to examine deterrence possibilities, and responding to attack are ascertained. The approach is intergrative, rather than examining each firm individually.

Competitive Forces

Rivalry (Existing and Potential). In examining the extent of rivalry, it is helpful to do so within the context of levels of industry concentration - i.e. low, medium and high. Given the nature of the study being concerned with new small firms, it might well be anticipated that the large majority (if not all) of the sampled firms would not be in highly concentrated industries, where entry (and exit) is restricted. In fact, out of the 17 firms examined, 7 are regarded as operating in low concentration industries, with 7 and 3 considered operating in medium and high concentrated industries, respectively.

Where low concentration is assumed to exist, the firms are in such industries as service, distribution, and manufacturing. The 7 firms include 1, 5, 9, 10, 13, 30 and 61. [See Table 1]

TABLE 1

Firm	Industry
1	Blind Cleaning
5	Knitwear Mfg.
9	Auto Repair
10	Industrial Cleaning
13	Holiday Tours
30	Wine Distribution
61	Theatrical Props Mfg.

All of the firms, except firm 61, regarded rivalry as being "generally strong" to "fierce" in all respects (i.e. price, quality, service, etc.). And, all firms are confronted by numerous similarly-sized competitors with similarly-small (insignificant) market shares. In fact, all firms noted market shares of no more than 5 percent (and usually less than 1 percent) of their main market. The exception, firm 61, considered competition to be "generally weak" and believed it held a market share of over 20 percent of its main market. However, the lack of regard for its rivals may be attributed to the "rapid growth" in market demand whereby "firms react to, rather than look for, orders". Firm 61's inclusion in the low industry concentration category is based on the fact that it is quite small (£7000 in total assets) and is faced with a large number of similarly-sized competitors. (viz. 11-30).

All of the firms indicated that entry and exit barriers were low. For example, little capital investment was necessary; e.g. premises could be leased or "one could start from home". Also, little or no product differentiation existed, (i.e. regarding physical attributes). Consequently, many of the firms (viz. 1, 9, 10, 13, 30 and 61) tried to place their emphasis on competence, service, delivery and sheer effort in order to acquire competitive advantage. Differentiation of products does apply for firms 5 and 13. However, this characteristic has more to do with the nature of their industries (i.e. knitwear and holiday tours) where intensive market fragmentation results from an increasing number of close substitutes. Firm 5 stated that their pursuit of product differentiation was simply in design of knitwear, which was in response to a growing fashion-oriented market. Firm 13 declared that in the tour industry "there is as much specialisation or differentiation as there are holidays". It is therefore easy to see how product differentiation as displayed in these two industries can actually attract, rather than deter, new entrants.

The primary obstacle to entry for these firms is customer contacts. According to firm 30, because of strong interfirm rivalry, establishing a profitable customer base might take 2-3 years. Firm 13 stated that without the co-operation of hotels, car rentals, and principally travel agencies, customers were unlikely to ever find out about the firm. To a lesser extent, the presence of intermittent overcapacity is a deterrent to entry. This barrier was particularly noted by firms 13 and 61 because of the seasonal nature of their products. The possible use of an entry deterring price was only cited by firm 9.

There are 7 firms considered in medium concentrated industries and all of them are involved in manufacturing. [See Table 2]

TABLE 2

Firm	Industry
11	Food Mfg.
17	Computer Software Mfg.
22	Cassette Tape Mfg.
25	Electronics
34	Bulk Bag Mfg.
52	Fencing Mfg.
54	Printing

Similar to those firms in low concentrated industries, these firms regard competition as "generally strong" to "fierce". Also, all of these firms, aside from firm 54, have insignificant market shares (viz. less than 5 percent). (Firm 54 believed that it held 11 - 20 percent share of its main market - i.e. Scotland.) However, these firms differ from those in the low concentrated industries in that they are generally confronted with fewer and larger rivals; these rivals sometimes include multinational companies. These firms also differ from those in low concentrated industries in that they are on the whole much larger in size with total assets ranging from £50,000 to £130,000.

Nearly all of the firms are in expanding markets to the extent where congenial and supportive intraindustry relations exist between small and large firms. The small firms are actually able to thrive because of catering to the small orders or contracts in which large firms have no interest. Moreover, there is the existence of subcontracting work given out to small firms by the large firms. For instance, firm 25 fills an important niche in the electronics industry by designing and manufacturing test equipment for the large firms. In this case, the principal customer is "rival" firms. Because of standard large-volume production facilities, large firms are unable and not wanting to satisfy specialised and small volume demands. Consequently, there is a recognised need in certain industries dominated by large firms for small firms.

The extent of barriers to entry and exit is mixed for these firms. Generally, attempting high volume production would be difficult for small firms because they would confront large rivals who are well-established with high strategic stakes, control significant scale economies, and maintain substantial financial reserves to effectively counter any threat to their market segments. The exceptions to this concern are illustrated by firms 17, 52 and 54. In the computer software industry where there are many multinational companies, firm 17 believed that there were generally low entry and exit barriers. Because of continued significant market growth (i.e. 15 - 30 percent/year), increased value added relative to fixed costs, no intermittent overcapacity, dynamic technological advances, and tremendous product differentiation or market segmentation, there is considered plenty of room for manoeuvrability and entry. Technical expertise and knowledge of the industry are the primary obstacles. Firm 25 indicated that similar characteristics apply to the electronics industry. However, attempting high volume production would be met with fierce resistance by the larger, more established, firms in the industry.

Firm 52 also argued that low entry and exit barriers exist, but for entirely different reasons, in the chestnut fencing industry. This industry has actually declined over the years due to lack of supply. Consequently, customers have had to turn to more expensive and inferior types of fencing. It is now a matter of re-educating the customer. At present, there are only a few firms in the industry with the larger firms located in southern England where chestnut is grown. And, they do not pose a threat (despite their large scale economies) to the Scottish and Northern Ireland markets because of prohibitive delivery costs and satisfaction with present markets. Firm 52 has basically rediscovered the market for chestnut fencing and is rapidly expanding as a result. However, because it believes it has only reached 5 percent of the market, the potential for all firms, whether existing or potential, is virtually barrier-free.

Finally, in yet another set of unique circumstances, firm 54 has actually directly confronted the industry leader (a multinational's subsidiary) which has resulted in dramatic growth and increased market share for the firm at the expense of the multinational rival. In fact, the multinational has had to subsidise its subsidiary's losses since firm 54 entered the industry. What is particularly unusual about this situation is that lamination of printed materials is a homogeneous product which should allow the multinational with its presumable large scale economies and substantial financial resources to dominate the industry. Of course, it did prior to firm 54's entry. However, because of firm 54's access to the most productive machinery available combined with significantly lower overheads and nurtured personal customer relations, it has now put the industry leader on the defensive. The success of firm 54 has nonetheless substantially increased the level of entry and exit barriers. Initially, upon entering the industry, the firm was fortunate in being able to acquire the necessary modern machinery because of an exceptional and inexpensive lease arrangement. Now, however, the suppliers expect only to sell, rather than lease, its machinery and at a substantial price (nearly £150,000/machine). Moreover, the buyer would have to wait 18 months. This has been a major deterrent to existing and potential rivals. Because lamination of printed materials is a homogeneous product customers are highly price sensitive. Consequently, firms have to rely on cutting unit costs in order to be profitable. The extent to which firm 54 is able to exert its low cost position is revealed in its belief of maintaining a 15 percent "elbow-room" in pricing. And, to a lesser extent, intermittent overcapacity does exist in the industry as a barrier due to the seasonality factor in demand, (e.g. calendars and Christmas cards).

In firms 22 and 34, the extent of entry and exit barriers is substantial. In the cassette tape manufacturing industry, firm 22 sees absolutely no scope for entry in the high volume segment of the market where very large and long-established firms (e.g. EMI and Decca) with huge scale economies and financial resources and high strategic stakes exist. Small firms (with rather large scale economies in their own right) are left with catering to small volume demands. Often a penny can make a difference in determining who wins any one contract. Entry deterring pricing is evident in all segments of the market given product homogeneity. Similar to firm 54, firm 22 was able to successfully enter the market because of its highly productive machinery. However, in the case of firm 22, it had to spend 5 profitless years developing the right machinery. The emphasis on low-cost production is due to product homogeneity. Firm 34 faces an identical set of circumstances in the bulk bag industry. The only difference is that its successful entry was based on developed customer contacts and industry experience acquired by the owner-managers prior to the firm's inception. Also, firm 34 has some limited scope for product differentiation on a smaller scale which the large established firms have no interest or capability due to inflexible and large production facilities.

Firms 2, 15, and 32 are regarded as being in high concentrated industries [See Table 3] where only a few large rival firms exist.

TABLE 3

Firm	Industry
2	Security Printer's Blankets
15	Cosmetics
32	Acrobatic Aeroplane Mfg.

Exceptional circumstances and highly specialised products have allowed for these new small firms to come into existence.

Firm 2 is confronted by five large (multinational) rivals throughout the world. Nonetheless, despite its relatively small size (£110,000 total assets), it has been successful in attaining 11 - 20 percent of the international market. And, it intends to make continual inroads in the market; viz. it expects market growth of 10 percent with 20 percent growth in its size over the next year. The firm's expected continued success is principally attributed to patent protection on some of its products and previous experience in the industry, which established necessary and prominent customer contacts (e.g. Bank of England). (The firm is the result of a management buyout). Not surprisingly, the industry is characterised by prohibitive entry and exit barriers, which consist of large capital requirements, patent protection, absence of channel access, specialised machinery, sophisticated technical expertise, and high strategic stakes.

Firm 15 is perhaps an "unfair" example of a new small firm in that it is a franchise. Although it was only started two years ago with a modest investment of £16,000, the franchisor has long been established as a large manufacturer with an extensive distribution and retail network throughout the U.K. Consequently, this "new small" firm has been able to overcome the significant entry and exit barriers of large capital requirements, intensive advertising, and high strategic stakes of a few long-established rivals that exist in the cosmetics industry. The large degree of product differentiation in the industry has assisted the firm in making a distinctive impact in the industry. Specifically, it has concentrated on inexpensive packag-ing and a refill policy.

The acrobatic aeroplane industry has long been dominated by two large American companies producing expensive, high-performance aeroplanes. The industry is one with tremendously high entry and exit barriers such as large capital requirements and stiff government regulations regarding inspection, safety, specification of all parts, in addition to registration and licensing. With the assistance of a large government grant, vast previous experience on the part of the owner-manager in the aeroplane industry, and identification of a large gap in the market for inexpensive, yet high-performance acrobatic ("kit") planes, firm 32 was able to overcome what would otherwise be insurmountable barriers to entry. All of the conditions were necessary, but not individually sufficient, for the firm to enter the industry. And, given the large capital requirements with the return on investment being long term, exit barriers are also considerable; it takes a minimum of six months to build and test one plane before it can be put on the market.

Customers. The firms' customers invariably act as an important competitive force. There is a tendency for a positive relationship between customer leverage and price sensitivity; i.e. the greater customer leverage, the more sensitive is price and vice versa. This relationship does occur for all the firms except 11, 54 and 61. Those firms (viz. 1, 2, 5, 10, 22, 30, 34 and 52) that experience notable customer leverage and price sensitivity exhibit similar characteristics. First, all of these firms' products are homogeneous or close substitutes with respect to their rivals' products. Consequently, the extent of customers' switching costs is much reduced. Second, all of these firms noted that there is a strong dependence on large (high volume) customers who consequently tend to exert a great deal of leverage and are quite price sensitive. And, third, most of the firms' customers are well-informed of the firms' rivals.

A few firms (viz. 22, 30, 34 and 52) expressed a need to actively cultivate personal relationships with customers and placed a premium on delivery and service in order to develop customer loyalty and therefore increase switching costs which would lower customer leverage and price sensitivity. For example, firm 22 stated that it made an "annual pilgrimage" to its largest customer in England to make a "social call". And, firm 30 does not simply sell wine, but offers to make-up wine lists and provide "own-label" bottles for its restaurant customers. Although this service enhances loyalty and price insensitivity, firm 30 indicated that it is only effective as long as its customers are experiencing "comfortable" performance. Finally, firm 34 found that in spite of selling a homogeneous good, loyalty could quite easily be gained through taking a personal interest in their customers' business and providing a prompt service. Most of its customers recognized the importance of the firm's product in enhancing their products' quality and the small cost of the firm's product relative to their total costs, which helped alleviate price sensitivity. Also, customers were unlikely to look to other firms if they were "generally satisfied" because they had an aversion to "disrupting continuity". This conservative approach has also meant a lack of interest in backward integration.

There are a number of firms (viz 2, 9, 15, 17, 25 and 32) that are actually successful in maintaining a significant degree of customer dependency; in other words, high switching costs and price insensitivity are appliable to certain customers. Four of the firms (i.e. 2, 17, 25 and 32) are involved in the development and manufacturing of high technology products in high profit (growth) industries. In the case of firm 2, for example, patent protection of certain products exists to insure high customer dependence. And, in the case of firm 25, it plays an essential role in the electronics industry by providing test equipment for larger firms in the industry. Test equipment by definition is produced in small volume, which large firms cannot justify on a cost or time effective basis. Consequently, the emphasis is primarily on quality and "quick turnaround", rather than price. The only concern of customer dependency is the performance of its customers; "if they are doing well, we are doing well".

Firms 9 and 15 do not appreciate the same degree of customer dependency as do firms 2, 17, 25 and 32 because of less technically oriented products and the availability of close substitutes. Price insensitivity is lower for firms 9 and 15 with "elbow-room" in pricing being no greater than 10 percent compared with the other firms enjoying "elbow-room" of more than 15 percent. Firm 9's major customer (which accounts for 50 percent of its sales revenue) is highly dependent on the repair of a particular type of automobile and places a premium on quality workmanship. Firm 15 maintains high customer dependence <u>once</u> the customer has tried its products (i.e. cosmetics) and found it with the necessary quality, despite the existence of close substitutes. Its cusomers are "obsessed" with their health and improving their looks; "once they find the right products, they stay with them". Therefore, customer motivation can be considerable. The firm also seeks to increase switching costs of customers by keep-ing them informed about established and new products.

Firms 11, 54 and 61 are exceptions to the positive relationship between customer leverage and price sensitivity. Firm 11, despite price sensitivity (only 4 - 6 percent "elbow-room") attributed to homogeneous products (viz. food items) and generally strong competition, does enjoy considerable low customer concentration. The largest customer accounts for only 15 percent of the firm's total sales, with other customers accounting for no more than 5 percent each. Consequently, there is little dependence on any one customer. And, even though switching costs are low, customers do not tend to "shop around"; customers are quite conservative and not well informed about rival firms. Firm 54 has a similar situation whereby customers are price sensitive because of product homogeneity. However, the firm is able to exert a relatively large degree of customer dependence because of its recognised tremendously low cost advantage over its rivals and fostered personal relationships with customers. Consequently, it enjoys more than 15 percent "elbow-room" in pricing. Finally, firm 61 is confronted with high customer concentration; it is dependent on 5 major customers. These customers provide "sporadic" business and are well-informed of the firm's competitors. Nonetheless, because products (viz. theatrical props) are quite specialised and are important to the quality of customers' products, customers are somewhat insensitive to price. This is reflected in the firm's comfortable pricing "elbow-room" of 10 - 15 percent.

Firm 13 is quite unique compared to the other firms in discussing customers as a competitive force. The firm is dependent on other tourist-related firms (e.g. travel agencies, hotels, and car rentals) for access to customers. The customers, on the other hand, tend to be dependent on these "middlemen" to link them with tour firms. Customers are often "upmarket", concerned with convenience, and ignorant of the industry. Therefore, they are likely to be insensitive to price. Customers' motivation tends to be quite strong because of their recognition of tour firms to actually save them money in terms of total holiday costs, which furthers price insensitivity.

Suppliers. The influence of suppliers on the firms is considered at three levels: (1) positive; (2) neutral; and (3) negative. The great majority of firms (viz. 1, 9, 10, 13, 15, 22, 25, 30, 52 and 61) regard suppliers as having a positive influence on their conduct and performance. Generally, the firms expressed an awareness of a large number of suppliers offering similar (competitive) products or inputs, quality and service with little or no threat of forward integration. Consequently, switching costs are quite low or even non-existent; as one firm stated, "it is merely a matter of picking up the telephone". Some firms noted that suppliers could be "played-off" one another in terms of price and delivery. Moreover, suppliers were often attributed with relieving cash flow difficulties. For example, firms 22 and 52 said that their suppliers kept them informed of expected shortages which allowed for adjustments in ordering to maintain necessary inventory levels. Firm 30 appreciated a two month credit policy with its suppliers, given that it had a one month credit policy with its customers.

Firms 5, 11, 17 and 34 consider their suppliers as having a neutral impact on their operations. Each of these firms noted a high concentration of suppliers providing essentially undifferentiated products or inputs. Also, forward integration by suppliers was considered common by firms 5, 11 and 34. However, switching costs were recognised as being quite low by all four firms. The reason is that the products or inputs tend to be homogeneous or standardised. In the computer software industry, for example, firm 17 stated that because research and development costs were exorbitant, component suppliers opted for standardised products emphasising high volume with low profit margins. In essence, the real threat of forward integration and the reliance on only a small number of suppliers was being offset by the competitive pricing of undifferentiated products or inputs.

Finally, firms 2, 32 and 54 asserted that suppliers actually exert a negative force in their industries. These industries are characterised by high industry and supplier concentration, great (or at least potential) profitability, and specialised products and/or manufacturing processes. Consequently, it is of little surprise that suppliers have considerable market power. Firm 2 stated that it was entirely reliant on one supplier for certain inputs that were "almost like prototype work". Firm 32 is also largely dependent on one supplier and the consequences have been dire. It was six months behind in production because of the supplier's delay. Moreover, every input has to be tested, approved and licensed before being sold by suppliers in the aeroplane industry. It is no wonder so few suppliers exist. Firm 32 is now considering backward integration as a means of alleviating much of its supply problem. Lastly, firm 54 has experienced tremendous growth (54 percent gross profits) because of its superior low cost advantage attributed to possessing the most modern machinery in the industry and insignificant overheads. At its inception, the firm was able to acquire the machinery because of an exceptionally inexpensive lease arrangement. Now that the supplier of this machinery has recognised its significance, the machinery is only available after an 18 month wait and at a very high price and "cash on the barrel".

Substitutes. Finally, in considering the influence of substitute products/services, it is useful to do so by placing firms in the following categories: (1) close substitutes; (2) inferior substitutes; (3) no available substitutes; and (4) creating substitutes. Firms 5, 10, and 15 are in industries with a proliferation of close substitutes and extensive market segmentation that tends towards overlapping and even replacement. In the cosmetic industry, for example firm 15 states that because customers are "obsessed" with health and beauty, they are always looking for something new. Consequently, the industry is constantly seeking to not only improve quality, but introduce new products. And, in the knitwear industry, firm 5 argues that the market is becoming increasingly fragmented, whereby both new and established firms are, more and more, emphasising differentiation resulting in close substitutes. This trend in the industry is in reaction to a more fashion-oriented market. Customers in both the knitwear and cosmetic industries have a high propensity to substitute. In the cleaning industry, however, where the propensity to substitute is low, firm 10 indicated that the emphasis has to be on salesmanship and promotion in convincing customers of the effectiveness of their cleaning materials. The relative value/price of alternative products is otherwise not discerned by the customers. Customers are basically immune to altering their purchasing habits. In all three industries, the availability of such a large number of close substitutes has significantly contributed to the fierce competition all three firms admit facing.

Firms 2, 11, 22, 30, 32 and 52 are in industries where substitutes are inferior or have a low relative value/price. Nonetheless, the performance of these firms tends to be mixed. And, inferiority has different connotations. For firms 2, 11 and 52, inferiority is concerned with inputs or products that clearly lack the right quality. Firm 2 noted that a major rival had introduced technical substitutes (i.e. man-made fabrics) with no success. Customers are rather conservative and prefer traditional materials. Firm 11 also remarked about the conservative attitude of customers being responsible for the lack of success of substitutes. Firm 52 has found that its principal customers will purchase softwood fencing only if chestnut fencing is in short supply. Customers are concerned with longevity which softwood is ill-suited. Softwood, however, would be preferable to the firm because production costs would be reduced by 10 percent.

Firms 22 and 32 find that substitutes in their industries are simply too "upmarket" or overpriced to be viable. According to firm 22, "it will take 20 years before the cassette tape becomes obsolete." And, there is no reason from the customers' viewpoint to want more quality than the digital cassette can provide;

"the existing product already has too much quality." Because of customer satisfaction in the cassette tape's quality, it will be the large, high-profit firms who will introduce digital cassettes in the market; they are the ones with the necessary financial resources and research and development activities. Firm 32 states that "up-market" acrobatic aeroplanes are twice as expensive as their aeroplane which provides similar performance.

Firm 30 is enjoying a growth period in the consumption of wine at the expense of beer and spirits. Wine is particularly gaining popularity in hotels and restaurants, the firm's major customers. There is a growing preference for wine because more and more people are taking their holidays to the Continent where more is consumed and simply because it is now fashionable, particularly amongst young people.

Firms 1, 9, 13, 54 and 61 contend that no substitutes are available, or likely to be, in their industries. In service industries, like auto repair and blind cleaning, in which firms 1 and 9 respectively exist, it is quite understandable. As firm 9 pointedly stated, "Robots can't do smashed windows." Firm 54 asserts that printed materials can either be laminated, varnished or neither. And, it is the type of printed material that determines its finishing. Therefore, varnishing is not considered as a substitute for lamination. Lastly, firm 61 argues that no "obvious" substitutes exist. Theatrical costumes are customised to suit each particular customer demand. A similar situation exists in the holiday tours industry for firm 13.

Finally, firms 17, 25 and 34 base their conduct and performance on actually creating substitutes. Firm 17 understands that the computer software industry is fundamentally concerned with continually introducing new products to meet changing consumer demands; there are always "new problems, new solutions". The firm, however, does not develop new technologies, but rather tries to adopt the latest "on-the-shelf" technologies. Firm 25 designs and manufactures test equipment for the larger firms in the electronics industry; consequently, it is always "one step ahead". And, similarly, firm 34 is always reacting to unique customer needs and specifications and, in effect, producing new types of bulk baks.

Competitive Strategy

Differentiation. Only firm 5 pursues this generic strategy, whereby it tries to appeal to all market segments in the knitwear industry. Its source of differentiation or uniqueness is design (viz. geometric patterns). In time, firm 5 may adjust its strategy towards a more focused approach, concentrating on particular customer types. However, because the firm has only been in existence for two years, it is admittedly quite ignorant of channels, customer locations and customer types. And, even though the firm desires such information, it feels it is "too costly or even impossible to obtain" at this time. Firm 5 is very much constrained by its size (£7000 in total assets). And, given that the market is quite fashion conscious, it might be unwise to concentrate only on certain segments. Therefore, all things considered, the firm regards a focus strategy as being risky.

Despite firm 5's ignorance of market and industry segments, it is quite aware of its own value chain and its possible reconfiguration to accentuate its uniqueness without unnecessarily increasing its costs. The firm realises that if it is to improve its competitive advantage, it must place greater emphasis on the value activity, marketing and sales. It has been modestly successful by preparing and distributing a catalogue featuring its products; this has "put a thumbprint on design". This action can only help emphasise differentiation without jeopardising its costs, especially since a grant was acquired for this purpose. However, a greater assignment of assets and costs to marketing and sales is still necessary; this value activity is fundamentally important as a source of differentiation.

Elsewhere in its value chain (viz. operations),firm 5 is contemplating reducing its dependence on outwork by purchasing new equipment. Purchasing new equipment will increase firm 5's sensitivity to the cost driver, capacity utilisation. New machinery is a fixed cost which creates a penalty for underutilisation. By maintaining a dependence on outwork, sensitivity to capacity utilisation is reduced since outwork is a variable cost. Reconfiguring the value activity, operations, with the purchase of new machinery, can only be justified with an appropriate (higher) volume based on increased sales. This concern clearly reflects back on the critical importance of the value activity, marketing and sales.

<u>Low cost</u>. No firm was undertaking a cost leadership strategy. This is not particularly surprising given that such

a strategy usually requires a firm to hold a large market share, whereby significant economies of scale can be fully realised [as discussed in Chapter 3]. And, none of the firms are on a large enough scale or long established to be the lowest cost producers market-wide; capital requirments are generally prohibitive.

Focus on differentiation. Firms 9, 11, 13, 17, 25 and 61 all focus on certain market segments with an emphasis on differentiation, particularly with respect to products. Given the small size of the firms, it is not surprising that in every case, except firm 17 location is regarded as a strategically relevant segment; i.e. the U.K. or a particular region is considered the main market. The exception, firm 17, despite its regard for the international economy as its main market, focuses on just one market segment, product variety (viz. computer software). It hopes to eventually expand into related segments (e.g. computer hardware). But, first it wants to build on its present products (referred to by thefirm as "bootstrapping").

Product variety, in addition to customer location, is an important strategic segment to firms 9, 11, 25, and 61. Firm 9, for example, has been successful at establishing and sustaining its strategy of providing top quality auto repair for a particular make of automobile. Firms 11, 25, and 61 have also been successful because of their expertise and quality being superior, as well as unique.

Customer type, in addition to customer location, is a significant strategic segment for firms 13 and 25. Firm 13 caters primarily to American tourists in Scotland who want "culture with a 'K'"; these customers are concerned with "seeing a bit of the country, visiting woollen mills, and staying in the right hotels." Sustaining the firm's strategic position is achieved through cultivation of customer channels (viz. hotels, travel agencies and car rentals). Firm 25 provides test equipment (viz. circuit boards) to larger firms in the electronics industry in Scotland on a subcontracting basis. Sustaining this focus strategy rests on establishing a reputation for providing the right quality, necessary (usually low) volume, and "quick turnaround".

Focus on low cost. Firms 1, 22, 52 and 54 have homogeneous products and are limited to certain strategic segments, where competitive advantage is achieved through low cost. Firm 1's strategic segments include customer location (the region), customer types (hospitals, schools and factories), and channels (safety and/or hygiene officers). The key cost drivers are the firm's discretionary policies regarding labour and type of customers. Firm 1 believes that it has the absolute minimum number of employees. And, by focusing on large, rather than small, customers, such as hospitals, allows the firm to effectively utilise its capacity (labour). The use of safety and/or hygiene officers are effective channels in gaining access to hospitals, schools and factories. The firm felt there was little opportunity to reconfigure its value chain to improve its low cost position.

Firm 22 must be content to stay in the "competitive fringe" of the tape cassette industry, where it satisfies the small volume needs in the UK market. Lack of size or capacity and domination of the upper-end (high volume) of the market by large (multinational) firms means that the firm will "never get a famous pop group".

Perhaps, the firm's most significant cost driver is timing. When the firm entered the industry 10 years ago, low volume demand was not being effectively satisfied. However, the firm believes that potential entrants in even the bottom-end (low volume) of the market would not confront many firms with significant scale economies in their own right. Having first-mover advantage has also allowed the firm to establish a solid customer base.

The firm recognises that if it is to continue its growth it must be prepared to assign more assets and costs to the value activity, marketing and sales. At present, assets and costs are principally assigned to operations (viz. labour, materials and machinery). Placing greater emphasis on marketing and sales would probably constitute a reconfiguration of the firm's value chain. With an increase in sales revenue, the firm would seek to exploit the cost driver, scale economies, by becoming more automated with an increase in machinery, rather than labour. Presently, the firm is more concerned with capacity utilisation.

Firm 54 has achieved what firm 22 hopes to in time; it has been able to effectively compete at the upper-end (high volume) of the market in Scotland. The combination of the most productive machinery available and low overheads due to a reliance on only a few employees have allowed the firm to not only confront, but also take away market share from its multinational rival, the industry leader. The firm intends to improve its low cost position further with the purchase of more machinery which will heighten scale economies even further; it is currently enjoying a 54 percent gross profit margin.

Finally, firm 52 is experiencing rapid growth primarily because of two cost drivers, timing and location. It has recognised that the demand for chestnut fencing has not been satisfied for a long time. Consequently, buyers have had to resort to inferior types of fencing. The firm believes that it has only tapped 5 percent of the market; "the potential is tremendous". Location is fundamentally important to the firm's success because it is the only producer in Northern Ireland and one of three in Scotland. Most of the rival firms are in southern England where chestnut is grown. However, high delivery costs keep them from being a viable threat. The firm cannot increase its capacity fast enough to satisfy this "rediscovered" market.

Focus on differentiation and low cost. Firms 2, 10, 15, 30, 32 and 34 believe that they try to satisfy certain market segments by emphasising both differentiation and low cost. Firms 10, 15, and 30 are in industries where competition is quite intense, customers are very price sensitive, and a large number of close substitutes exist. Consequently, the key value activities are marketing and sales and operations. Firm 10 tries to differentiate its products (i.e. soaps) by altering colour and aroma and commissioning a chemist to prepare an entirely new compound unique to the firm. These actions do not affect its costs significantly. Similarly, firm 30 provides own-label bottles and prepares wine lists for its restaurant customers to enhance differentiation without negatively affecting its costs. Firm 15 avoids "glamourous" packaging as a means of distancing itself from its rivals in the cosmetics industry. This differentiation action contributes to its emphasis on low cost. The significant cost driver for firms 10 and 15 is their discretionary policy regarding service and delivery. Customers expect prompt delivery and will tend to provide further business given they are generally pleased with the products' quality and consider the price reasonable. Relatedly, location is fundamentally important as a cost driver (particularly for firm 15); being accessible can greatly influence customer motivation.

Firms 2 and 34 manufacture both standardised ("run-of-the-mill") and specialised products. Consequently, there is a dual emphasis on low cost and differentiation. Essentially, firm 2 tries to focus on product segments with high value lines. Its principal cost driver is its discretionary policy regarding labour payments. Firm 2 prefers to have its workers on salaries, rather than pay them wages. This policy has resulted in higher productivity. Another cost driver for the firm is learning. As employees of the previous (now defunct) firm, the owner-managers of the present ("phoenix") firm know which product lines to avoid. Essentially, sustaining its stategy requires the control of salaries and acquiring patents for certain products.

Firm 34 is primarily concerned with satisfying the specific demands of large intraindustry firms. Location is perhaps the most important cost driver. The firm's major supplier and principal customers are local. Consequently, inventory and delivery costs are kept at a minimum and close customer contact is maintained, which ensures exact product specifications and quality. Capacity utilisation is also a significant cost driver; overheads are kept at an absolute minimum. The emphasis on low cost is attributed to the ease with which imitation can occur, despite specialised needs of customers.

Firm 32 offers a unique and low cost alternative to expensive, high-performance acrobatic aeroplanes. Its one-seater, "kit" aeroplane can provide similar performance to the rivals' products and at "half the price". The firm is able to achieve its superior cost position because of insignificant overheads and labour costs. Therefore, capacity utilisation is the cost driver that will sustain its cost leadership position. Nonetheless, the critical value activity is not operations, but marketing and sales. In a sense, it is creating a market niche; customer awareness is fundamental to the firm's success.

Defensive Strategy

Inreasing barriers to entry. Most of the firms indicated that they did not try and "consciously" increase entry barriers. These firms attributed lack of size, experience, and market influence as the fundamental reasons. The firms were intent on simply establishing a customer base by emphasising quality products, dependable service, prompt delivery, a fair price, and personal relationships with customers. The result, hopefully, would be increased customer switching costs. (These characteristics of the firms and their attitude influenced many of the responses on Defensive Strategy. There was the general feeling that the firms were more concerned with creating, rather than defending, market niches.) Some firms went as far as to convey a rather cavalier attitude; as one firm pointedly stated, "My own competitiveness will deter them."

The outstanding exceptions, firms 22 and 54, were undertaking an active policy to increase entry barriers by increasing its scale economies with the purchase of capital equipment. Both firms are in industries where the emphasis is on low cost because of product homogeneity.

Increasing retaliation which challengers can expect. The firms generally viewed retaliation with reluctance, if not disdain. The firms often expressed ignorance and a "wait-and see" attitude. One firm went as far as to say, "We keep ourselves to ourselves." Moreover, retaliation was sometimes considered too costly and time consuming. In many instances, firms preferred to view their industry as a "fraternity" of "good" competitors where a "general understanding" existed to maintain "healthy" profit margins for all. Price-cutting, for example, was regarded as unnecessarily disruptive, if not counter-productive. The extent of retaliation as expressed by most of the firms was that of matching guarantees and prices. However, such actions would not be taken to the point of "buying" business; the firms were always conscious of the "bottom line", profit.

Firm 52 is the lone exception to avoiding significant retaliatory measures. The firm is having to consider expanding its manufacturing operations in Northern Ireland to counter the likely encroachment into this market by a government subsidised firm from Eire. Firm 52 expressed having a deep commitment in the market because of having first-mover advantage in a market with tremendous potential.

Lowering the inducement on attack. Reducing profit margins and managing competitors' assumptions as a means of lowering the inducement on attack is generally uncommon amongst the firms. Nearly every firm expressed a disinterest in lowering their profit margins. Most firms strongly believed that they were already offering their products/services at a competitive price and emphasised non-price factors (e.g. quality and delivery) as a means of reducing customer price sensitivity. Moreover, many firms stated that pricing was already "rock bottom". Also, reducing prices might precipitate harmful retaliatory measures by rivals which could undermine the firms' market position.

Managing competitors' assumptions was usually based on "just getting on with one's business". Trying to project a high profile by providing customer satisfaction through fair pricing, dependable service, and quick delivery was the basic approach used by the firms. Firm 15 went further and stated that having a prime (i.e. "high street") location greatly impressed upon its rivals the firm's serious commitment. Firm 54's rapid growth and successful confrontation with the industry leader (a multinational company), resulted in increased market share for the firm at the expense of its larger rival, which greatly impressed the other firms in the industry. On the one hand, the small firms were encouraged to see a similarly-sized firm expose the weaknesses of the industry leader. Yet, on the other hand, they were wary of what the implications of firm 54's success could be for them.

Using industry scenarios to examine deterrence possibilities. An industry scenario is not a forecast, but "an internally consistent view of an industry's future structure". [Porter, 1985, p.448] They are used to assess important implications of competition and changing industry structure. Most firms did not involve themselves in scenario planning because of lack of information or anticipation of little or no change in competitive forces and rivals' strategies; the firms were admittedly myopic in their outlook. Some preferred to simply wait and react to whatever changes might occur. As one firm stated, "We would not know what to do until it happened." However, firms 2, 34 and 54 did appreciate the importance of industry scenarios. Firms 2 and 54 said that they engaged in scenario planning on an active basis, but did not care to elaborate.

Firm 34 has been forced to consider industry scenarios because of its own disruptive behaviour in the printing industry in Scotland. It has made substantial inroads in the industry leader's market share due to its superior low cost performance. The firm is now anticipating the likely retaliatory actions of the industry leader to regain its lost market share, before it deteriorates further. The most likely scenario is one where the industry leader employs predatory pricing (i.e. unit cost exceeding price). The firm believes that this is likely given that the industry leader is a multinational company and can subsidise this tactic from its other operations' profits. Consequently, the firm has been explaining this likely move to its customers and stressing that it can only be short-term given the losses the industry leader will incur. Once the industry leader has reasserted its dominance, customers can look forward to paying higher prices. The firm also plans to increase its capacity with the purchase of more machinery which will increase scale economies and lower unit costs further.

Responding to attack. Nearly every firm expressed concern for keeping abreast of changes in their industry and market. Attending trade shows was mentioned by a majority of firms as being the best source of information on market trends, rivals, suppliers, pricing, and technical advances. Moreover, trade shows were used by some firms to enhance their image and cultivate customer contacts. Other sources of information include suppliers, customers, trade magazines and journals, courses and trade contacts. Three firms found that rivals' advertising provided important insight into their strategies and what products were doing well.

Discussion on "responding to attack" was limited by nearly all the firms to seeking information. Most firms have not had to deal with responding to attack because they were so new to their industry and/or felt little chance of threat because of industry stability. In most cases, the firms (as well as their rivals) did not view themselves as threats and could therefore expect little or no confrontation.

Summary

As indicated in Table 4, nearly every firm operates in either a low or medium concentrated industry; only 3 firms operate in high concentrated industries (The firms are arranged according to level of concentration in both Table 4 and Table 5). The firms that are in low concentrated industries generally regard competition as stong. As also shown in Table 4, these firms admit facing many similarly-sized rivals with similarly-insignificant market shares. Moreover, entry and exit barriers tend to be easily overcome. In particular, capital requirements are typically quite small. Consequently, firms intent on achieving competitive advantage place a priority on dependable service, quick delivery, competitive pricing, and an intensive sales effort. Establishing a large customer base is the critical concern of these firms if they intend to be profitable and survive. Those firms that operate in medium concentrated industries also consider competition to be generally strong and possess insignificant market shares, as seen in Table 4. However, all of these firms are in manufacturing industries dominated by a few large firms. Consequently, these firms must be content with being in the competitive fringe where there are a number of similarly-sized rivals. The competitive fringe exists because of the large firms being unable or disinterested in small and specialised volume demands due to their standard large-volume production facilities.

Generally, the extent of customer influence is positively related to the degree of price sensitivity; ie. the more price is sensitive, the greater is customer leverage and vice and versa. Firms that noted significant customer leverage and price sensitivity

TABLE 4

Firm	Industry	Market Definition	Market Share %	Industrial Concentration	Entry/Exit Barriers	Product Diff.
1	Blind Cleaning	Region	<1	Low	Low	Little
5	Knitwear Mfg	Intl.	<1	Low	Low	Yes
9	Auto Repair	Region	<1	Low	Low	Little
10	Industrial Cleaning	Scotland	<1	Low	Low	Little
13	Holiday Tours	Scotland	1 - 5	Low	Low	Yes
30	Wine Dist.	Region	31-50	Low	Low	Little
61	Theat. Props. Mfg.	Scotland	21-30	Low	Low	Little
11	Food Mfg.	Region	1 - 5	Medium	Medium	No
17	Computer Software Mfg.	Intl.	<1	Medium	Medium	Little
22	Cassette Tape Mfg.	U.K.	<1	Medium	High	No
25	Electronics	Scotland	<1	Medium	Medium	Yes
34	Bulk Bag Mfg	U.K.	1 - 5	Medium	High	Little
52	Fencing Mfg.	Scotland	1 - 5	Medium	Low	No
54	Printing	Scotland	11-20	Medium	High	No
2	Security Blankets Mfg	Intl.	11-20	High	High	Yes
15	Cosmetics	Region	>15	High	High	Yes
32	Aerobatic Aeroplane Mfg	Intl.	n.a.	High	High	Yes

TABLE 5

Firm	Rivalry	Customers	Suppliers	Subst.	Strateg
1	Strong	A	A	C	FLC
5	Strong	A	B	A	D
9	Strong	C	A	C	FD
10	Strong	A	A	A	FDLC
13	Strong	C	A	C	FD
30	Strong	A	A	B	FCLC
61	Weak	C	A	C	FD
11	Strong	C	B	B	FD
17	Strong	B	B	D	FD
22	Strong	A	A	B	FLC
25	Strong	B	A	D	FD
34	String	A	B	D	FDLC
52	Weak	A	A	B	FLC
54	Strong	C	C	C	FLC
2	Medium	B	C	B	FDLC
15	Medium	B	A	A	FDLC
32	Weak	B	C	B	FDLC

SUBSTITUTES:
A - Close
B - Inferior
C - None Avail
D - Creating

CUSTOMERS:
A - ↑ Customer Leverage
↑ Price Sensitivity
B - ↓ Customer Leverage
↓ Price Sensitivity
C - Unique

SUPPLIERS:
A - Positive
B - Neutral
C - Negative

STRATEGY:
D - Differentiation
FD - Focus on differentiation
FLC - Focus on Low Cost
FDLC - Focus on Differentiation and low cost

sold products that were either regarded as homogeneous or close substitutes. (It is interesting to note that the firms in high concentrated industries maintained strong customer dependency which is much attributed to significant product differentiation. [See Tables 4 and 5]) Also, these firms are particularly dependent on large (high volume) customers. And, the firms' customers are well]informed about the firms' rivals. Consequently, these firms emphasised the development of customer loyalty by providing quality service and prompt delivery and cultivating personal relationships with customers. Developing customer loyalty increased customers' switching costs and reduced price sensitivity. Most of the firms that experienced customer dependency and price insensitivity manufactured high technology products. Thus, there was an emphasis on the right quality and delivery, rather than price.

The large majority of firms regard suppliers as having a positive influence on their operations. This finding is irrespective of the level of industry concentration as revealed in Tables 4 and 5. There are often a large number of suppliers available offering similar products or inputs at competitive prices. Consequently, switching costs tend to be very low. The few firms [viz 2, 32 and 54] that consider suppliers as a negative force are limited to a few suppliers because of the products or inputs being highly specialised. It is interesting to add that firms 2 and 32 are in high concentrated industries.

Substitutes are generally regarded as a positive or neutral competitive force. Most of the firms believe that substitutes are clearly inferior, do not exist, or are introduced [created] by the firms themselves. Those few firms (viz 5, 10 and 15) that have products that confront close substitutes are in industries where extensive market fragmentation exists.

In the examination of the firms' competitive strategies, all of the firms (with the exception of firm 5) indicated a pursuit of a focus strategy where the emphasis is on either low cost, differentiation, or both. [See Table 5] The principal strategic segment is location.

The firms are intent on satisfying demand because of their accessibility. Normally, they cater to a particular locale or region; lack of resources and experience prevent them from expanding their geographic market. To a lesser extent, product variety and customer type are strategically relevant segments. The most significant value activities are marketing and sales and operations. There is a general need to assign more costs and assets to marketing and sales to increase potential customers' awareness and generate greater sales turnover. Consequently, the most important cost driver tends to be capacity utilisation, rather than scale economies. In most cases, firms must fully utilise their capacity in order to be profitable and sustain their existence.

Generally, the firms were relatively reticent on defensive strategy; the firms seemed more concerned with <u>creating</u>, rather than defending, their market niches. The firms attributed inadequate resources, experience, information, and market influence as the reasons. For instance, only two firms were significantly involved in increasing barriers to entry, namely by increasing their scale economies with the addition of new machinery. Moreover, many firms preferred to view their rivals as "good" competitors who shared the "general understanding" of avoiding disruptive practices such as predatory pricing and encroachment on others' market niches. Consequently, there was no need for considering retaliatory action and reducing inducements on attack. Also, nearly all the firms did not actively consider possible industry scenarios. The firms either expected little change in their industries or lacked sufficient information. Many firms simply preferred to wait and react to whatever industry changes might occur. However, nearly all the firms were involved in obtaining more information about their industries. Sources of information include trade shows, suppliers, customers, and trade journals.

CHAPTER VI

Finance as a Barrier to Inception and Development

Introduction

The major deterrent to entrepreneurship is the inability to acquire financial resources. If an entrepreneur is even to have the chance at being successful in "carrying out new combinations" - viz. launching a business enterprise - he must first be successful in obtaining the necessary finance. As Schumpeter [1934] stated: "The entrepreneur - in principle or as a rule - does need credit ... in order to produce at all, to be able to carry out his new combinations, to become an entrepreneur." [p.101][1] Consequently, the entrepreneur must have the ability to create confidence and therefore be able to convince capitalists of the proposed enterprise's viability.

Moreover, as Penrose [1959] correctly observed: "... there is a relation between entrepreneurial ability and the finance a firm can attract; and that difficulties attributed to lack of capital may often be just as well attributed to a lack of appropriate entrepreneurial services, in the sense that a different entrepreneur in the same circumstances might well achieve different results."[p.39]

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1. The importance of credit is absolute in Schumpeter's theory of economic development. (As discussed in Chapter II), Schumpeter's circular flow is entirely dominated by consumption. Schumpeter [1934] stated: "In the circular flow there would be on the one hand no such rich source, out of which to save, and on the other hand essentially less incentive to save." [p.72] Consequently, if innovation or "new combinations" are to be introduced and disrupt the circular flow, it must necessarily be financed by credit (viz. "creation of money by banks").

Marshall [1890] agreed that "ability always finds the necessary capital", but went further and stated that "no limit to the amount of borrowing is assumed. We hear of an efficient entrepreneur being able to 'borrow in one way or another almost any amount that he may need'". [p.311] However, as Steindl [1947] pointed out: "Contrary to Marshall's assumption, there are in fact very strict limits to borrowing, especially borrowing by small entrepreneurs. In practice it is in the first instance the creditors who see to it that the proportionate indebtedness of a firm is limited." [p. 5] It is generally acknowledged that no matter how viable the prospective enterprise, investors often expect the entrepreneur to act in the capitalist's capacity to at least the extent that they do themselves; the issue of moral hazard is rarely overlooked.

Most new small firms do not have adequate financial resources. If they did, they would not necessarily start small. Nevertheless, many new small firms do succeed, do raise additional capital, and do grow into large firms. Being able to start and run a new firm effectively on a shoestring and enable it to reach a size and position where its general credit standing is well established is a necessary and special attribute of the successful entrepreneur [Penrose, 1959]. The suggestion is that the real test of an entrepreneur's ability is not in successfully launching a new enterprise, but overcoming a shortage of money at critical times in its development. The needs and growth opportunities of a business are ever-changing, which is particularly true for the new small firm trying to implement appropriate competitive strategy to achieve competitive advantage. Also, because of capital indivisibilities, smaller firms tend to require larger amounts of finance in order to expand, relative to their net worth, than bigger firms. Given that many entrepreneurs have nearly exhausted their personal finances in starting their firms and tend to experience liquidity or cash flow problems in the early years, there is a tremendous reliance placed on external finance [Binks and Coyne, 1983].

Fundamentally, the success of new small firms, in particular, depends on scrupulous financial control, especially with respect to appropriate financial leverage or "gearing" levels and prudent cash flow management. To quote Edwards and Townsend [1958]:

> Often it is proper that the business should suffer an early death: it lacks either the right ideas or the right men. But it sometimes happens that a firm with ideas and men reaches a point where the future hangs on someone's skills or luck in scraping up the cash to meet tomorrow's payroll.... Most men who have built up businesses, most who have tried and failed, would echo the words of Anthony Fokker, the Dutch aeroplane designer and manufacturer: "... I was able to struggle along by watching every penny, hoping that things would brighten up sooner, but the question of finance was to give me grey hairs time and again, before I finally came out of the clear. Of all the troubles I have had, all the changes I have run, I think the question of financing myself has caused me the most grief." [p. 29]

Inception

For an entrepreneur setting-up a new business, he must have adequate information about such things as the market, industry, government assistance, premises, and, not least, finance, if he is to have the best possible chance of success. Often times, he does not have adequate information and must turn to others for advice. Of course, the entrepreneur will never have compleat information and, according to Schumpeter [1934], must ultimately rely on "intuition, the capacity of seeing things in a way which afterwards proves true." [p. 85]

It is generally understood that the bank manager and accountant are regarded as the obvious, if not the most important, sources of advice, particularly for those inquiring about obtaining external finance. The research findings support this belief in that out of 52 cases where advice was sought prior to starting business, 45 indicated that they had contacted their bank manager and/or accountant.

Over the past few years, there has been a plethora of publicly sponsored initiatives (e.g. The Loan Guarantee Scheme, The Enterprise Allowance Scheme, and The Business Expansion Scheme) and a variety of well-publicised advisory services and agencies (viz. enterprise agencies). Consequently, the prospective entrepreneur is no longer limited to relying on his bank manager and accountant for general assistance. Anyway, it is somewhat naive to expect a bank manager or an accountant to provide comprehensive business advice. Few have the knowledge to do so effectively and many are simply not willing to act in such a generalist capacity. Furthermore, it has been argued that given that new small firms are typically ignorant of, or underestimate, the value of financial advice, accountants (in particular) have little incentive to invest in an expertise they are unlikely to sell [Kaplan, 1948; Bolton Committee, 1971; Woodcock, 1984; and Robson Rhodes, 1985].

Banks have traditionally played an essential role in assisting the birth of business enterprises. The questionnaire data add credence to this view in that 34 firms contacted their bank manager for advice in advance of starting business; no other source of advice received more citations. [See Table 1] Furthermore, in 10 instances the bank manager was regarded as the most important source of advice. And 27 firms ranked the bank manager no less than third in importance. The bank manager's significance is not particularly surprising given that small firms are invariably reliant upon some external financing and will initially look to its bank manager to meet this need [Wilson Committee, 1979; Storey, 1982; and Binks and Coyne, 1983]. In fact, undercapitalisation is usually the major concern for small firms namely for those just starting [Oxenfeldt, 1943; Steindl, 1947; Kaplan, 1948; Penrose, 1959; and Cross, 1983]. Furthermore, because there is some correlation between longevity of a firm and its access to information about finance, potential entrepreneurs are likely to look no further than their bank manager about obtaining the necessary finance; new firms are hesitant about investing in much time to seek out other sources of funding [Bolton Committee, 1971; Wilson Committee, 1979; and Bannock, 1981].

The results of the questionnaire show that banks are, far and away, the most significant source of external finance, with family and friends a distant second. [See Table 2] Specifically, out of 33 firms that started with the use of external finance, 28

TABLE 1

SOURCE OF ADVICE

SOURCE	Level of Importance						TOTAL
	1	2	3	4	5	6	
Family and Friends	9	3	7	1	0	0	20
Bank Manager	10	7	12	3	1	1	34
Accountant	9	13	6	3	1	0	32
Enterprise Trust	12	12	3	4	1	1	33
Scottish Development Agency	7	4	5	7	2	1	26
Local Government	3	2	2	2	2	1	12
Other	2	2	0	0	0	0	4

TABLE 2

SOURCES OF INITIAL EXTERNAL FINANCE

SOURCE	Level of Importance					TOTAL
	1	2	3	4	5	
Bank	14	8	5	1	0	28
Family and Friends	8	0	1	0	0	9
Hire/Purchase	2	4	1	0	0	7
Lease	1	4	1	0	0	6
Equity	2	3	0	0	0	5
Local and Regional Govt.	2	0	2	0	0	4
Scottish Development Agency	1	1	1	1	0	4
British Steel	2	0	0	0	1	3
Development Corp.	1	0	0	0	0	1
Industry Dept. (Scotland)	0	1	0	0	0	1
Enterprise Trust	0	0	1	0	0	1
Advanced Contracts	0	0	1	0	0	1
Finance Company	0	0	0	1	0	1

used bank funds. And, in 14 of these 28 firms, banks were regarded as the most important source of finance. Moreover, in 9 cases no other source of finance was used. Family and friends were only cited in 9 firms.[2]

Arguably, one of the great attractions to bank finance is the overdraft facility. The overdraft facility is the most common form of short-term finance used by businesses primarily for the purpose of funding working capital needs and/or cash flow difficulties. It is generally the least costly type of finance as interest is charged only on the outstanding debit balance of the bank each day.

Criticism is often raised that small firms would choose to borrow more than they do but that they are restricted in doing so by their banks [White, 1984]. It is assumed that banks want to avoid taking risks particularly with new small firms since such enterprises have no track record in which to judge their performance and lack sufficient equity capital. Consequently, banks are thought to limit their lending whereby the "gearing" or leverage ratio - defined here as the proportion of a firm's equity and retained profits financed by borrowing[3] - does not generally exceed 1:1. In other words, banks lend only to the

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2. Storey's [1982] survey of 152 new independent firms in Cleveland also showed that the major source of external funding was banks followed by family and friends.

3. In calculating the "gearing" ratios of the sample's firms, leasing was not considered; of course, banks do take this expense into account when extending loans. Also, loans made to the firms by the owners were treated as equity, not debt. And, only the amount actually used of an overdraft was treated as debt. Finally there was no distinction made between long and short term debt in the figuring of "gearing" ratios.

extent where the known assets of the business are able to cover the firm's debt in the event of liquidation. However, the questionnaire data suggest that banks are not as inflexible as sometimes thought. Out of 28 firms that borrowed from the bank in starting their operations, 9 did not have to provide some sort of security. Out of these 9 firms, banks were the only source of external finance in 5 firms and 4 firms cited other sources of external finance in addition to the bank. It should be added that in each of the 5 firms the "gearing" ratio was no greater than 1. Furthermore, 13 of the 28 firms had "gearing" ratios in excess of 1. In 10 of these firms multiple sources of external finance were used. However, 11 firms did provide security. And, this security extended beyond the assets of the firm (i.e. floating charges) to include personal guarantees, life policies of the owner-managers, heritable securities, stock exchange securities, and guarantors. [see Table 3] Though banks seemed concerned about limiting their risk, there was the suggestion that banks had a greater appreciation for the capital needs of new small firms in that nearly half the firms using bank finance of some sort had initial "gearing" ratios greater than 1. The involvement of other sources of external finance and the willingness of owner-managers to provide security extending beyond the assets of the business have encouraged banks to lend to what would be considered risky firms where the debt is greater than the net worth.

The questionnaire results also show that banks do not significantly act as a barrier to new small firms in quest of external finance. Out of 40 firms that were wholly self-financed at their

TABLE 3

SECURITY FOR INITIAL EXTERNAL FINANCING

SECURITY	NUMBER OF MENTIONS
Personal Guarantee	9
Life Policies	6
Guarantors	5
Stock Exchange Securities	2
Heritable Securities	4
Floating Charges	7
	33 *

* 23 firms provided security

TABLE 4

OBSTACLES TO OBTAINING INITIAL EXTERNAL FINANCE

OBSTACLE	Level of Importance			TOTAL
	1st	2nd	3rd	
Lack of personal finance	11	4	0	15
Establishing the idea a market existed	11	6	0	17
Lack of previous business success	2	1	0	3
Difficulty in producing satisfactory financial statements	3	1	4	8
Previous employment experience	2	0	1	3
Other	2	0	0	2

inception, 15 confronted obstacles to obtaining external finance. (Alternatively stated, 25 firms were not looking for outside funds to start operations.[4]) Out of the 15 firms that were unsuccessful in otaining external finance, 7 did not seek any advice and in only 4 cases was a bank consulted. The obstacles confronted by firms unable to attract any kind of external finance were principally the inability to establish the idea a market existed for the firm's products, insufficient owners' injections, and inability to produce satisfactory financial statements (e.g. cash flow forecasts, projected profit and loss statements, and pro forma balance sheet). [See Table 4] With proper advice and consequent better preparation of business plans, these obstacles may have been overcome. And here the bank manager could have been of assistance.

Banks' participation in the provision of loan finance to new small firms have been heightened in recent years with the Government's introduction of The Loan Guarantee Scheme (LGS) and The Business Start-up Scheme more familiarly known as The

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4. The high number of self-financed start-ups indicates a strong preference to avoid any external finance (at least initially) as a means of keeping costs down and avoiding interference by outsiders in the management of the firm. (This concern for maintaining complete control is further pronounced in that only 5 firms issued equity in order to start. [See Table2] Also, many firms expressed a need to establish a track record whereby they could be in a more favourable position to attract outside funds and to take advantage of a growth opportunity. Generally, firms did not like to be saddled with a great deal (if any) of debt at the beginning of its operations. Another disincentive to borrowing was the common condition of a provision of security. For new, small firms it is not unusual for borrowing to be secured by the assets of the business <u>and</u> the personal assets of the owner-managers or guarantors. Out of 23 firms that provided security in order to obtain initial external finance, in only 3 instances were the assets of the firm solely acceptable as security.

Enterprise Allowance Scheme (EAS). The LGS was launched in 1981 based on the belief that insufficient funds existed for feasible business ventures; the finance was unavailable because proposers were unable or unwilling to provide guarantees or security which financial institutions deemed necessary or did not have a track record on which the venture's success could be judged. Essentially, the innovative attraction of the scheme was that the Government would act as guarantor for 80 per cent of each loan (with an upper limit of £75,000 extending over 2 - 7 years). This aspect greatly relieved the issue of security for participating banks in lending to what would otherwise be considered risky businesses. Moreover, from the proposers' vantage point, banks could only ask for security on assets of the business; personal guarantees from the firm's owners or their personal assets could not be considered for security. Initially, the LGS was a three year pilot with an allotment of £50 million for each of the years. However, because of excess demand, the £150 million committment was doubled a year after its introduction. By 1985 well in excess of £500 million had been lent to more than 16,000 businesses under the scheme by the 30 financial institutions involved, including all the clearing banks except the TSB, a number of smaller banks and merchant banks, together with the ICFC [Woodcock, 1985]. However, progress reports of the scheme undertaken by the chartered accountants Robson Rhodes [1985] revealed that appraisals of applications and the monitoring of the use of the loans were inadequate. They also found that borrowers showed little understanding and care for the financial management of their businesses. Consequently, more than £60 million of the loans were called and about two out of five businesses were in receipt of loans failing [The Guardian, 1985]. The scheme was intended to be self-financing given that a premium of 3 per cent was imposed by the Government on each loan. However, given the losses involved, once the three year pilot was concluded the Government reduced its guaranteed proportion of the loan to 70 percent, leaving the lenders to carry a larger proportion of the risk, naturally leading to greater caution on their part. Also, the premium charged for the guarantee was increased to 5 per cent to reduce the cost to the taxpayer and effectively adding a further 3.5 per cent (i.e. 70 percent of 5 percent) to the overall interest charges. Of course, there was never any intention of it being a cheap loan scheme and borrowers were expected to pay a full commercial charge for the loan. Although borrowers did not seem to mind about the original interest cost, the increase in the premium has had a dramatic effect in the number of loans issued. National Westminster Bank, for example, which had 37 per cent of the market for guaranteed loans has seen the number of proposals it has accepted be reduced by 50 per cent [The Guardian, 1985]. Finally, the Government's decision to allow banks to ask for personal assets as security, rather than just those of the business, has also contributed to the decline in the number of scheme loans. The questionnaire data support the growing lack of interest in the GLS in that only 2 firms had undertaken a guaranteed loan.

Alternatively, The Enterprise Allowance Scheme (EAS) has consistently played an influential role in stimulating new firm formation and attracting bank finance. The EAS was introduced in 1982 by the Government to assist unemployed people who want to start their own business by paying a flat rate, taxable allowance of £40 per week for 52 weeks. To qualify people have to be out of work or under notice of redundancy for at least 13 weeks and have at least £1000 available to invest in the business, which can be in the form of a bank loan or overdraft. The stipulated minimum of 13 weeks is to allow for proper consideration and preparation of the busness to be undertaken, which may include finding premises, conducting market research, acquiring finance, etc. In the first year of the scheme some 28,000 places were taken up and in the following year 46,000 people benefitted. Moreover, 86 per cent of the participants who used the full year's allowance were still trading three months after their allowance had come to an end [The Guardian, 1986]. Clearly, the scheme has contributed to creating some stability in that crucial initial year of operations when cash flow can be particularly problematic.

The Government's own confidence in the value of the scheme was indicated by the allocation of a further £325 million to enable the scheme to continue until March 1988 [Woodcock, 1985]. In support of the EAS, banks have taken a positive attitude and response towards it, with the Midland Bank, for example, offering free business banking service to those participating in the scheme. Also, banks are more inclined to lend to new businesses where the owner-manager(s) is involved in the scheme. There is some indication of this in the research findings. In the sample, 15 firms reported participation in the EAS. Out of these 15, 7 firms started their business with the assistance of bank finance. In another 7 firms that participated in the scheme, there was no desire expressed to use any external finance. This is confirmed by the fact that these 7 firms stated that they did not confront any obstacles to obtaining outside funds. The remaining unaccounted firm of the 15 established under the scheme's assistance was able to attract other (non-bank) financing.

The questionnaire data and Government assistance (viz. the LGS and EAS) support the premise that banks are being more instrumental in the growth of nascent firms. At the very least, banks appear not to be acting as a barrier to new firm formation. Banks may well be, as Schumpeter [1934] so vigourously argued, "capitalist par excellence" and "ephors of the exchange economy".

Accountants are important to prospective entrepreneurs because of their specialised knowledge. They are of considerable aid in preparing a business plan for the firm in need of raising finance. The success of any business depends on a highly developed competitive strategy [as discussed in Chapters III and V] and having the necessary resources (personnel and capital) to effectively impliment it. And, it is the business plan which is the instrument by which potential investors are persuaded of the firm's likely success. The accountant's specific contribution to a business plan is preparing the necessary financial documents, including the pro forma balance sheet, projected profit and loss statement, and cash flow forecasts. The accountant can also ascertain the particular tax implications which can greatly determine the type of business - e.g. sole trader and limited company - the prospective entrepreneur should undertake, as well as the kind and timing of capital investments. Using an accountant can greatly offset the risk of displaying financial naivety and ineptitude on the part of the entrepreneur when presenting a business plan to potential investors. Often there is an inverse relationship between the financial expertise of owner-managers and the size and age of a firm; the smaller and younger a firm the greater the reliance on an accountant. According to a recent unpublished study by Milne and Thomson [1984] of Glasgow University, the financial management skills of owner-managers of new firms are in need of a considerable upgrading.

The accountant's importance to new small firms is supported by the questionnaire date. Out of 51 firms that sought advice prior to starting, 32 noted their accountant. [See Table 1] It compares favourably with the bank and enterprise trust. And in 22 cases, the accountant was ranked either first or second in importance. Also, in 22 instances, firms that sought an accountant's advice indicated that they did not confront any obstacle to obtaining finance to start their business. Of the remaining 12 firms that did use an accountant and admitted having to overcome obstacles, only 1 cited difficulty in producing satisfactory financial statements as an obstacle to acquiring outside finance. The others primarily had difficulty in establishing the idea a market existed for their products. It should be added that 11 firms that used an accountant in starting their operations did not seek external finance. Nonetheless, the evidence does indicate that the accountant does play a significant role in helping firms attract external funding and begin trading.

In addition to the bank manager and accountant, the other significant source of advice is the local enterprise agency (more commonly referred to in Scotland as the enterprise trust). Almost from their inception in 1978, enterprise agencies have played a vital role in the formation and growth of small businesses. Evidence of their increasing role is seen in their proliferation, particularly over the past few years. There were 61 enterprise agencies in April 1982, 103 a year later and 180 by the middle of 1984. By June 1986, there are expected to be 300 in Britain [Financial Times, 1985]. The primary function of enterprise agencies is to provide advice. What makes them so attractive given that there are other sources of advice is the nature of the agencies. They are typically set up jointly by the private sector and local authorities. The involvement of the private sector is particularly with regard to the lending of experienced managers or specialists for an extended period of time (usually 9 months to several years). Secondees from (normally) large corporations and financial institutions are recognised for providing the best possible consultancy. And, it is free, independent, and non-political. In addition to providing general business advice, enterprise agencies can readily find suitable premises and attract financing for viable projects because of their personnel's respect and influence with the financial community. Finally, enterprise agencies' effectiveness is partly attributed to being accessible because they are at the local level.

A recent report produced by the Centre for Employment

Initiatives [1985] examined the effectiveness of 12 enterprise agencies in England, Scotland and Wales. The survey was based on 370 in-depth interviews. Essentially, the report was very supportive of the effectiveness of enterprise agencies. Clients and others rated the agencies in first position in terms of contribution to their specific businesses and to small firms generally. Eleven per cent of those starting in business and 9 per cent of those already in business felt they would not have started or would have gone into liquidation without the assistance provided. A further 53 percent of start-ups and 34 per cent of existing firms felt that it would have been more difficult to start or that they would have taken longer to do so, or that they would have so many people employed without assistance from an agency.

The research findings also support the important influence of enterprise agencies. In 33 instances an enterprise trust was noted as a source of advice; this compared favourably with the bank manager and accountant. [See Table 1] Given that 25 per cent of the firms in the sample were started prior to 1982 when there existed just one enterprise trust in Scotland [i.e. the Ardrossan, Saltcoats, Stevenston Enterprise Trust, Ltd. (ASSET)], the number of firms citing an enterprise trust as a source of advice understates the importance of enterprise trusts. The questionnaire data also show that the enterprise trust was noted as either being the most important or second in importance in providing information by 24 firms. The accountant and bank manager, however, were cited 22 and 17 times respectively in this regard.

Finally, in examining those firms that received some special finance (i.e. government grants, reduced rental on premises, etc). [See Table 5], 20 firms that considered the special finance helpful and/or necessary to starting-up sought the advice of an enterprise trust; this figure compares favourably with the bank manager and accountant with 23 and 20 citations respectively. [See Table 6] Furthermore, in 13 cases where the special finance was considered necessary to start-up, the enterprise trust was used for advice, only the bank manager was noted as often. Given the rapid growth of enterprise trusts and their unique and necessary role in small business development, it is not surprising that the data, should find them at least as important as the bank manager and accountant.

The questionnaire data shows the Scottish Development Agency as fourth in importance as a source of advice with 26 responses. [see Table 1] Many firms indicated reluctance in dealing with the bureaucracy of this government entity. Moreover, there was the common expression that the SDA was not interested in assisting the particularly small firm. In fairness to the SDA, the tremendous growth in the number of enterprise trusts over the past few years has shifted the SDA's emphasis away from advice to new firms towards more indepth counselling for established firms. Nonetheless, the SDA has a wealth of comprehensive expertise and resources to assist all businesses, irrespective of type, size or age.

The remaining sources of advice noted include family and friends (20 responses), local government authorities (12 responses), and other (4 responses). [See Table 1] Other included solicitor,

TABLE 5

SPECIAL FINANCE SCHEMES	NECESSARY	HELPFUL	TOTAL
Enterprise Allowance Scheme	7	8	15
Employment Grant	3	15	18
Investment Grant	5	13	18
Reduced Rental on Premises	5	14	19
Special Tax Credits	2	4	6
Other	2	1	3
TOTAL	24	55	79

Necessary: The firm would not have started without the special finance.

Helpful: The firm would have started without the special finance.

TABLE 6

SOURCE OF ADVICE	SPECIAL FINANCE	
	Helpful and/or Necessary	Necessary
Family and Friends	12	6
Bank Manager	23	13
Accountant	20	11
Enterprise Trust	20	13
SDA *	17	8
Local Government	8	3
Other	0	0

* Scottish Development Agency

Industry Department (Scotland), ICFC, and individuals in industry. Advice from family and friends was usually with regard to the question of obtaining finance. In 7 out of 8 cases where a firm considered family and friends as the most important source of external finance, family and friends were also cited as a source of advice.[5] Local authorities concerned with nurturing small businesses tend to work closely with local enterprise trusts. Their involvement is particularly helpful with respect to the provision of industrial premises and finance. However, the assistance of local authorities does not appear to be substantial for the firms in the sample.[6]

Development

If a new small firm intends to survive and develop it must have additional finance. There are primarily three types available: (1) earnings; (2) equity; and (3) borrowed funds. Usually, the new small firm is reliant on more than one type. The relative use of these types of finance is the result of an equilibrium between risk and return on investment. The smaller the share of net worth (i.e. owners' equity and retained earnings) in the total

5. Outside capital for a new, small firm can usually only be acquired from family and friends; "no one else will be able to guage the true worth of the main asset of the business - the personalities of those who will run it". [Andrews, 1955, p.241]

6. See Storey [1982] for further evidence of the role of local authorities. Storey's data showed that local authorities are an important source of information on premises and other information as well as being the major planning authority, but were an unimportant source of financial advice.

funds of the firm, the greater is the risk to the lenders and to the owners themselves. The risk is accounted for in two principal ways. First, irrespective of a firm's performance, interest payments on borrowed funds must be made according to the arrangements set forth in the loan agreement. And, the greater the outstanding debt vis-a-vis the net worth of the firm, the greater the risk of not being able to service it. Second, and perhaps even more important, any changes in liquidity needs or increased demands from creditors for payment will be more difficult to accommodate of such a firm owing to the low proportion of owners' funds in its financial structure. The owners' funds which do not have to be repaid serve as a cushion to protect a firm against such changes. For these reasons, the risk of such a firm not being able to meet its debt obligations is more pronounced than in the case of a firm in which the proportion of borrowed funds is substantially smaller. Consequently, if there is the desire to minimise a firm's risk, the owners will strive to reduce its level of debt in proportion to its equity holdings. The level of financial leverage or "gearing" is a measure of the security a firm provides on its borrowings.

The questionnaire data suggest that new small firms are highly dependent upon borrowed funds. In the short life of the sample's firms only 12 never used debt finance, as indicated where the highest "gearing" ratio equals zero. [See Table 7] And, out of 34 firms that started with the use of borrowed funds, 18 had a "gearing" ratio greater than 1. Even though the number of firms using borrowed funds increased from 34 to 61, the riskiness

TABLE 7:

FIRM	PGEAR	BGEAR	HGEAR	LGEAR
1	.33	0	.33	0
2	0	.50	.50	0
3	.25	0	.25	0
4	4.00	2.00	4.00	2.00
5	.30	3.50	3.50	0
6	1.00	2.00	2.00	1.00
7	.50	********	********	.25
8	0	0	0	0
9	0	0	1.00	0
10	.50	1.00	2.00	.50
11	3.00	4.00	8.00	3.00
12	.25	0	.50	0
13	.75	3.00	3.00	.75
14	.75	0	.75	0
15	0	0	0	0
16	.50	0	********	0
17	0	0	0	0
18	1.00	0	1.00	0
19	3.00	2.00	3.00	2.00
20	0	0	0	0
21	.03	.25	.25	.03
22	0	0	0	0
23	.59	.59	.59	.59
24	.33	0	.50	0
25	.08	0	.25	0
26	0	0	0	0
27	.75	0	.75	0
28	0	0	0	0
29	.50	.50	.60	.50
30	0	0	.43	0
31	0	0	0	0
32	2.50	2.50	2.50	2.50
33	3.00	1.00	3.00	1.00
34	.50	0	.50	0
35	.66	.50	.75	.30
36	.20	1.70	1.70	.15
37	.30	0	.60	0
38	.25	0	.25	0
39	.50	.33	.50	.33
40	.20	0	.20	0
41	0	0	0	0
42	0	0	0	0
43	1.40	1.40	1.40	1.40
44	1.50	8.80	8.80	1.50
45	********	0	********	0
46	0	0	.50	0
47	.33	.33	.33	0
48	.01	********	.01	.01
49	.01	0	.01	0
50	1.50	0	2.00	0
51	.10	2.40	4.20	.10
52	1.00	10.00	10.00	1.00
53	1.00	7.00	7.00	1.00
54	.33	0	.33	0
55	.33	0	.33	0
56	********	********	********	********
57	.55	.36	.55	.36
58	1.00	3.00	3.00	1.00
59	.25	0	.25	0
60	4.00	0	4.00	0
61	2.50	2.50	2.50	2.50
62	0	0	1.50	0
63	.10	3.00	3.00	.10
64	0	0	0	0
65	1.00	1.00	1.00	1.00
66	.10	0	10.00	0
67	.25	.50	.50	.25
68	3.00	3.00	3.00	3.00
69	1.00	3.00	6.00	1.00
70	.33	.33	1.00	.33
71	0	0	0	0
72	.50	.50	.50	.50
73	.14	0	.33	0

PGEAR - present "gearing" ratio
BGEAR - starting "gearing" ratio
HGEAR - highest "gearing" ratio
LGEAR - lowest "gearing" ratio
******** = not given

of firms tended to decline in that only 11 firms at present have a "gearing" ratio greater than 1 as compared with 18 that started operations with a ratio greater than 1.

This concern for decreasing the level of debt relative to the level of equity is further supported in examining the firms' expectations of their "gearing" ratios over the next 3 years. [See Tables 8 and 9] Out of the 11 firms with a present "gearing" ratio greater than 1, 8 expressed a desire to reduce their level of financial leverage at least over the next year. Moreover, a total of 31 firms expected their "gearing" ratio to drop over the next year. The major reasons for this drop were an anticipation of increased profits and retirement of debt. And, 12 out of 13 firms that thought their "gearing" ratio would remain unchanged over the next year had a present "gearing" ratio no greater than 1. (In fact, 7 of the 12 firms had a ratio of zero.) Finally, in examining the financial leverage expectations of the firms over the next year, 19 firms expected their "gearing" ratio to increase, namely because of the acquisition of debt finance. However, 16 of these firms had a present "gearing" ratio not in excess of 1. In other words, these firms did not feel that additional debt would jeopardise their level of safety. Expectations for the second and third years further support the firms' concern for reducing the level of their debt in proportion to their net worth, in that 33 firms anticipated their "gearing" ratios to drop in the second year and 26 firms expecting the same in the third year. There were only 7 responses for both years that regarded their "gearing" ratio to increase. Unsurprisingly, the number

TABLE 8

EXPECTED CHANGES IN "GEARING" OVER THE NEXT THREE YEARS

CHANGE	Year 1	Year 2	Year 3
Fall	31	33	26
Rise	19	7	7
Stay the same	13	17	16
Do not know	10	16	24

TABLE 9

REASONS FOR EXPECTED CHANGES IN "GEARING"
OVER THE NEXT THREE YEARS

REASON	Year 1	Year 2	Year 3
Increase in earnings	36	39	32
Increase in equity	4	4	3
Increase in debt	22	13	8
Losses	0	0	1
Retirement of debt	22	27	25
Unsure	10	16	25
Other *	4	5	5

*Other refers to profit-taking and dividends payout of firms indicating "do not know" rose for the second and third years to 16 and 24 respectively from the first year's 10. Many of these firms stated that it would be "sheer guesswork" to think what their firm's financial structure would be in 3 years, particularly because they had not even been in operation for that long.

Aside from the concern of maintaining low levels of debt relative to equity in order to minimise risk, new small firms may desire to restrict their reliance upon borrowed funds initially to better enable it to secure finance when a big opportunity presents itself [Robinson, 1966]. Establishing a good record may not be easy for a firm that is burdened with alarge amount of debt to service in the early years. However, the firm with minimal debt can more readily service it and therefore establish a record that will enhance its borrowing position. There is some suggestion of this in the questionnaire's findings. [See Table 7] There were 54 firms with a "gearing" ratio no greater than 1 when they started operations. (Of these 54 firms 38 had a beginning "gearing" ratio of zero.) And, since starting, 34 firms had increased their level of "gearing" indicating an increase in borrowing. In fact, 10 firms borrowed to the point of placing their "gearing" ratio above 1. This suggests that these firms had built up enough confidence in their lenders through their performance to place the firms in what might be regarded as a risky position.

Minimising risk is only one aspect in the use of borrowed funds; the other factor is the increase in profitability or, more importantly, the generation of positive cash flow, whereby the cash receipts exceed the cash disbursements (as discussed later).

A borrowing firm generating a positive cash flow despite the additional cash outlay of interest payments will increase the owners' equity and thereby reduce the level of "gearing". In this case, the return to the owners is greater than that to the lender. In other words, borrowed funds can be used to finance growth and also reduce risk. In addition to the return to the lender being fixed, rather than being based on the firm's performance, the other major advantage to borrowed funds is that the interest is recognised as a tax-deductable expense. In effect, the cost of borrowed funds is cheaper than paying dividends on equity where double taxation applies.

Aside from the equity owners inject into a firm, the provision of external equity is usually viewed with disdain by small firms in that it is regarded as an erosion of control in the firm and of the personal and financial rewards. Also, access to equity from the Unlisted Securities Market (USM),[7] ICFC and venture capitalists is usually beyond the reach of the new small firm given the large capital amounts involved. [Binks, 1979; Jarret and Wright, 1982; and Foley, 1985]. The USM and venture capital funds primarily provide equity for those firms in need at a later stage in their development. Also, the costs of placement (over £40,000 on the USM) are generally prohibitive and the amounts

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7. The USM was set up in November 1980 partly in response to the 1978 Wilson Committee report on small firms, which drew attention to the prohibitive expense and difficulty for many young companies in acquiring a full public listing in the stock market. The single largest source of equity capital for small businesses is the USM. The USM has the particular attraction of only requiring 10 percent, rather than 25 percent, of equity funds to be sold to the public.

provided (e.g. the average investment by the ICFC is £120,000) are far too large for the firms under consideration. Finally, the hidden costs of management time taken up in preparing for a flotation can be a substantial barrier.

The questionnaire findings are supportive of new small firms' preference for debt, rather than equity, finance. As Table 2 shows, only 5 firms used some type of external equity in starting their operations. And, as Table 9 reveals, no more than 4 firms in any of the next 3 years anticipate using external equity. Moreover, the use of debt finance has been helpful in generating growth for the sample's firms. According to Table 10, where the change in the firms' equity (new worth) are deducted from the changes in total assets (present and starting) and changes in "gearing" ratios (present and starting), 53 firms (out of 63 with sufficient information) improved upon their starting net worth. In 42 of these firms, debt finance was used. Clearly, debt finance was instrumental in fostering growth as well as improving the financial structure.

As for internal earnings or positive cash flow, young small firms intent on being competitive and making necessary and long-lasting inroads into the market are invariably unable to create large liquidity reserves by which to finance capital expansion. In support, Binks [1979] stated: "In embryonic form, firms are often maintained with a view to their potential rather than actual profitability. Where this is not the case, it is rare for a firm's profit margin to be sufficiently high in its initial stages to cover the large proportionate increases in turnover and

FIRM	SASSET	BGEAR	PASSET	PGEAR	Δ EQUITY
1	£ 16000	0	£. 16000	·33	£ -4000
2	70000	·50	105000	0	+58333
3	5000	0	4000	·25	-1800
4	20000	2·00	60000	4·00	+5333
5	1500	3·50	7000	·30	+4913
6	65000	2·00	88000	1·00	+22334
7	1000	********	90000	·50	?
8	0	0	100000	0	+100000
9	5000	0	9000	0	+4000
10	10000	1·00	30000	·50	+15000
11	130000	4·00	130000	3·00	+6500
12	70000	0	500000	·25	+400000
13	4000	3·00	15000	·75	+7572
14	1500	0	1800	·75	-472
15	16000	0	65000	0	+59000
16	10	0	50000	·50	+16657
17	5000	0	100000	0	+95000
18	10000	0	40000	1·00	+10000
19	35000	2·00	55000	3·00	+2083
20	3500	0	5000	0	+1500
21	8000	·25	32000	·03	+29668
22	2000	0	100000	0	+98000
23	16000	·59	25000	·59	+9000
24	0	0	4000	·33	+3000
25	2500	0	20000	·08	+16019
26	2000	0	4000	0	+2000
27	1000	0	1000	·75	-429
28	3000	0	50000	0	+47000
29	20000	·50	20000	·50	0
30	8000	0	27000	0	+19000
31	6000	0	0	0	-6000
32	35000	2·50	35000	2·50	0
33	14000	1·00	40000	3·00	+3000
34	5000	0	50000	·50	+26334
35	22000	·50	350000	·66	+195334
36	10930	1·70	415000	·20	+30962
37	3500	0	3500	·30	+3250
38	15000	0	15000	·25	-3000
39	18500	·33	72000	·50	+34125
40	1000	0	30000	·20	+24000
41	100000	0	100000	0	0
42	1000	0	50000	0	+49000
43	17000	1·40	17000	1·40	0
44	35000	3·80	350000	1·50	+136429
45	600	0	12000	********	?
46	2000	0	5000	0	+3000
47	2000	·33	30000	·33	+28000
48	175	********	900000	·01	?
49	0	0	0	·01	?
50	600	0	30000	1·50	+11400
51	60000	2·40	95000	·10	+68717
52	15000	10·00	50000	1·30	+23656
53	3000	7·00	10000	1·00	+4625
54	0_2	0	180000	·33	+135998
55	12000	0	20000	·33	+3000
56	0	********	0	********	?
57	10000	·36	300000	·55	+186195
58	7000	8·00	9000	1·00	+3722
59	8000	0	25000	·25	+12000
60	1000	0	30000	4·00	+5000
61	0	2·50	7000	2·50	?
62	0	0	0	0	?
63	3000	3·00	150000	·10	+12890
64	5000	0	70000	0	+65000
65	20000	1·00	25000	1·00	+5000
66	220	0	50000	·10	+45255
67	22000	·50	22000	·25	+2933
68	16000	3·00	14000	3·00	-2000
69	9000	3·00	20000	1·00	+8000
70	0	·33	0	·33	?
71	0	0	0	0	?
72	12000	·50	34000	·50	+14667
73	95000	0	200000	·14	+80439

SASSET - starting total assets
BGEAR - starting "gearing" ratio
PASSET - present total assets
PGEAR - present "gearing" ratio
Δ EQUITY - change in equity (i.e. owners' injections and retained earnings)
******** - not given

consequently [the] capital base required for the kind of expansion under consideration here." [p. 36] Though Binks is essentially correct in recognising the inadequacy of earnings generated from operations as a source of funds to finance expansion plans, he is wrong in his use of the word profitability. Alternatively, the emphasis must be on liquidity or operational cash flows (a phrase borrowed from Eckford [1984]). A firm can be highly profitable but if it cannot convert profits into "real cash", particularly at critical times, it faces the prospect of bankruptcy. As Lee [1985] pointedly stated: "Profit is an abstraction; cash is a physical resource." [p. 93] The emphasis on cash flow, rather than profitability, is especially applicable to the new small firm where debtors (particularly large customers) are notorious for their slow payment in recognition of the new small firm's zealousness in generating sales and establishing customer goodwill.

The questionnaire data suggests that new small firms do indeed have cash flow problems. When asked whether cash flow difficulties were ever confronted, 52 firms (71 per dent of the sample) replied in the affirmative. The most significant reasons attributed to liquidity problems were an insufficient overdraft facility and delinquent debtors. [See Table 11] One might argue that delinquent debtors were more significant than an insufficient overdraft facility since an insufficient overdraft facility could be the <u>result</u> of a larger than expected number of bad customers and not the <u>cause</u> of poor positive cash flow. Overinvestment also ranked high as a cause of cash flow difficulties. Overinvestment could well be concerned with stock rather than capital goods,

TABLE 11

REASONS FOR CASH FLOW PROBLEMS

REASON	Level of Importance					TOTAL
	1	2	3	4	5	
Insufficient overdraft facility	16	13	2	1	0	32
Delinquent debtors	16	8	3	1	0	28
Overinvestment	9	6	5	2	0	22
Inadequate credit policy with suppliers	4	2	0	1	2	9
Delinquent suppliers	3	1	1	1	0	6
Inadequate credity policy with customers	1	2	2	0	0	5
Other	4	1	0	0	0	5

TABLE 12

REASONS FOR DEBT FINANCE SINCE START-UP

REASON	NUMBER OF FIRMS*
New or expanded premises	19
Purchase of plant and equipment	25
Increase in stock	17
Additional employees	11
Cash flow problems	22

* 44 firms used debt finance since start-up

which might suggest lack of proper management. In fact, every firm except one that cited overinvestment also cited an insufficient overdraft facility, delinquent debtors, and/or inadequate credit policies. All three of these reasons are associated with working capital. Finally, in examining the reasons for firms acquiring debt finance since they began operations, the questionnaire findings show that out of 44 firms 22 acquired debt finance to overcome cash flow problems. [See Table 12] In 16 of these firms, debt finance was acquired for other reasons as well.

CHAPTER VII

Conclusion

The objective of this thesis was to obtain a greater knowledge and understanding of the development of the new small firm by means of an empirical investigation. The intention was to be positivist without providing obvious normative implications. Moreover, this investigation was performed partly in response to the lack of research that has been devoted to the direct examination of new small firms in Scotland.

The research undertaken for this thesis had three important stages: (1) un-structured design work; (2) the administered questionnaire; and (3) the semi-structured interview. The unstructured design work was accomplished in the capacity of consultant for the Ardrossan-Saltcoats-Stevenston Enterprise Trust Ltd. (ASSET). This experience provided the opportunity to observe and actually participate in the inception and development of new small firms in the Ayrshire region. Consequently, the acquired insight assisted in the formulation of the administered questionnaire and the semi-structured interview and the interpretation of the data. Also, the experience with ASSET provided the necessary contacts or channels (viz. enterprise trust directors) by which the sample was generated.

The semi-structured interview is concerned with how competitive strategy is formulated, implemented, and sustained. Essentially, entrepreneurial activity is being examined. The aim of "carrying out new combinations" is the achievement of competitive advantage. The extent of competitive advantage is measured by profit and illustrated by the development of the firm. The semi-structured interview was conducted amongst a subset of the sample. Therefore, some of the data from the administered questionnaire supplemented the data from the semi-structured interview in the analysis of competitive strategy.

The semi-structured interview adopts Porter's [1980 and 1985] framework and Reid's design. It contains three distinct, yet related, sections: (1) competitive forces; (2) competitive strategy; and (3) defensive strategy. The first section examines the competitive forces - i.e rivalry (existing and potential), customers, suppliers, and substitutes - which fundamentally determine the generic competitive strategy undertaken. The second section analyses how the generic competitive strategies - i.e. low cost, differentiation, and focus - are implemented. The "value chain" is an important tool used to systematically assess a firm's activities which are the ultimate source of competitive advantage. These activities include inbound logistics, operations, outbound logistics, marketing and sales and service. The third section discusses the defensive strategies available to a firm to sustain competitive advantage. In particular, increasing barriers to entry, increasing retaliation which challengers can expect, lowering the inducement for attack, using industry scenarios, and responding to attack are considered.

In the examination of the evidence in Chapter V, the competitive forces, existing and potential rivals, are arguably the most compelling. Nearly every firm operates in either low or medium concentrated industries. All of these firms regard competition as fierce. And, these firms generally confront similarly-sized rivals with similarly-insignificant market shares. For those firms in low concentrated industries, entry and exit barriers are quite low. In particular, capital requirements tend to be very small. Achieving competitive advantage is therefore based on emphasising quality service, prompt delivery, fair pricing, and marketing and sales. All of the firms operating in medium concentrated industries are involved in manufacturing and are much larger than those firms in low concentrated industries. In the medium concentrated industries, the firms generally operate in the "competitive fringe" because of the existence of large firms who dominate the large volume part of the market. The "competitive fringe" exists because of the large firms being unable to satisfy or disinterested in small and specialised volume demands because of their standard large-volume production facilities.

The degree of customer influence tends to be directly related to price sensitivity; i.e. the more sensitive is price the greater is customer leverage and vice and versa. The firms that experienced significant customer leverage and price sensitivity sold products/services that were regarded as close substitutes or homogeneous with respect to their rivals' products/services. These firms tended to be highly dependent on large (i.e. high volume) customers. Moreover, customers were generally very knowledgeable about the firms' rivals. Consequently, the firms often undertook an active policy of developing customer loyalty by emphasising service, delivery, and personal relationships as a means of increasing customers' switching costs. Those firms that enjoyed customer dependency and price inconsistency manufactured high technology products. Customers were concerned with the right quality and quick delivery, rather than price.

Most of the firms consider suppliers as being a positive competitive force. Usually, a number of suppliers are available offering similar products/inputs at competitive prices. Little or no switching costs tend to be involved. The small minority of firms that regard suppliers as being negatively influential require specialised products/inputs of which there are few suppliers.

Substitute products/services tend to be regarded as either a positive or neutral competitive force. Nearly all of the firms assert that substitutes are either clearly inferior, non-existant, or introduced by the firms themselves. The few firms that consider substitutes a threat are in industries where extensive market fragmentation exists because of the rapid introduction of new, yet similar, products (e.g. knitwear and cosmetics).

In considering competitive strategy, all of the firms (except one) follow a focus strategy with the emphasis on either low cost, differentiation, or both. The most important strategic segment is location (viz. locality or region). Due to lack of size and experience, in particular, the firms generally have to concentrate their operations on a limited geographical area. To a lesser extent, product variety and customer type were noted as significant strategic segments. Clearly, the prominent value activities are marketing and sales and operations. Usually, there is an admitted lack of costs and assets allocated to marketing and sales. Firms recognise the importance of increasing their customer base and sales turnover, but lack the resources and marketing expertise. Operations was often mentioned as an important value activity. Firms had to be intent on fully utilising capacity in order to be profitable. The emphasis on scale economies, as opposed to capacity utilisation, was less of a concern.

The firms generally did not "consciously" pursue a defensive strategy. Most of the firms were still trying to establish their niche in the market. The firms also cited lack of resources, experience, information, and market power as reasons. Moreover, some firms believed that defensive strategy was unnecessary given that their competitors were viewed as part of a "fraternity" that frowned upon disruptive behaviour such as predatory pricing and encroachment on others' market niches. There was also the view commonly held that industry structure did not significantly change. Therefore, industry scenarios were rarely contemplated as a matter of strategic planning. Nonetheless, most of the firms did actively seek information to try and improve their competitiveness. Primary sources of information include trade shows, customers and suppliers.

Entrepreneurship - viz. the inception and development of a firm - fundamentally depends on adequate financing. In Chapter VI, evidence from the Finance section of the administered questionnaire was examined. Traditionally, the bank manager and accountant are considered the most important sources of information for the new small firm [Woodcock, 1984]. The research findings support this view in that no other sources of information were more often cited. In fact, out of 52 firms that sought advice initially, 45 noted the bank manager and/or the accountant. The other prominent source of advice cited was the enterprise trust. New small firms seek information on finance, in particular. Under-capitalisation is most often the principal concern for new small firms [Steindl, 1947; Penrose, 1959; Cross, 1983]. Otherwise, perhaps, small firms would not necessarily start small. Therefore, an accountant is important in the preparation of the financial statements and business plan used to persuade capitalists, such as banks, to provide the necessary finance.

The primary source of external finance for the new small firm is the bank [Wilson Committee, 1979; Storey, 1982; Binks and Coyne, 1983]. Out of 33 firms that started with the assistance of external funds, 28 borrowed from the bank. And, in half of these firms, bank funds were considered the most important source of external finance. A particular attraction of the bank is the overdraft facility whereby interest is only paid on the amount actually borrowed, rather than the amount made available.

Often banks are criticised for their reluctance to engage in lending to new small firms because of their lack of a track record and owners' injections [White, 1984]. Banks are widely considered to limit their lending in order that the "gearing" (leverage) ratio - i.e. proportion of debt to owners' equity - be no greater than 1:1. However, the evidence suggests that banks are not so inflexible in their lending practices to new small firms. Although banks seemed concerned with limiting their exposure to risk, they appeared to be appreciative of the firm's capital needs. Nearly half of the firms that borrowed from banks at their inception had a "gearing" ratio greater than 1:1. The participation of other sources of external finance and the willingness of owner-managers to provide security beyond the assets of the firm have encouraged banks to lend to what would be regarded as risky ventures.

Perhaps, not surprising is the fact that 40 firms (over 50 percent of the sample) started with no external finance. Moreover, 25 of these firms did not even seek external finance at their inception. Many firms wanted to avoid interference by outsiders. Also, a number of firms preferred to wait and become established to enable them to be in a more favourable borrowing position and take advantage of growth opportunities. Furthermore, many owner-managers simply did not want to use their personal assets as security.

Since starting operations, only 12 firms never used some kind of debt finance. However, the level of risk tended to decline for the firms as a whole. Only 11 firms at present, compared with 18 firms at inception, have a "gearing" ratio greater than 1:1. Generally, there is the concern to reduce the level of debt vis-a-vis equity over the next three years. Specifically, 31 firms expect their "gearing" ratio to decline over the next year. Nearly every firm with a present "gearing" ratio greater than 1:1 anticipated a reduction due to increased profits and the retirement of debt. Over the next year, however, 19 firms believed their "gearing" ratio would increase namely because of the acquisition of debt finance to fund development. However, 16 of these firms had a "gearing" ratio not exceeding 1:1.

Internal earnings, in comparison to external finance, tend to be considered an inadequate source of funds to finance the new small firm's development [Binks, 1979]. This concern is reflected in the cash flow problems small firms often confront particularly in their early years. The research findings lend support to this view. Over 70 percent of the sample experienced cash flow difficulties at one time or another. The most significant reasons were an insufficient overdraft facility and delinquent debtors.

Finally, it must be said that the time constraint has prevented the established data base from being fully exploited. In particular, the data from the Pricing, Costing, and Sales and Competition sections of the administered questionnaire remain virtually untouched. (However, it should be stated that the data from these three important sections have been carefully "neglected" in view of the fact that G. C. Reid is credited with the formulation of these sections.) And, a more rigorous integration of the numeric data from the administered questionnaire and the textual information from the semi-structured interview is needed to be performed. Also, there is the need to apply advanced statistical methods, namely with respect to the sequencing and ranking aspects of the administered questionnaire. These opportunities promise to further enhance our understanding of the entrepreneurial activity and development of the new small firm.

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Over the past few years, attention has been shifted away from the large, corporate enterprise to the small enterprise as the major source of employment creation and economic growth. Significant support for the small business has come from the Scottish Development Agency, Scottish Business in the Community, and Enterprise Trusts. This support has been primarily in terms of attracting finance, finding suitable premises, and offering advice regarding drawing-up a business plan, marketing, cash flow, etc. Unfortunately, not enough attention in terms of research has been given from the University level, which could help promote awareness for further support.

It is our contention that the prospects for success of the small business can be enhanced by increasing the knowledge of such enterprises' strategies to establish their place in the market. Proper management (in addition to adequate finance) is often a major obstacle in achieving and maintaining sucess for the small firm. Consequently, we are undertaking a comprehensive study of 70-80 small businesses by examining first-hand their policies and strategies to not only survive, but prosper and grow. Our study involves the questionnaire, structured interview, and case study methods.

With your co-operation, we would very much like to take an hour of your time to go through our questionnaire. This objective exercise can be of immediate benefit to your business in that you will perhaps learn (or at least be reminded) how much you know about the conduct of your business and its effectiveness in relation to your competitors. Certainly, once the study has been completed (sometime late this summer) the findings will be made available to you if you so desire. Of course, the utmost in confidentiality will be upheld.

If you should have questions regarding our study or ourselves, please contact Mr Peter Duke, Director, EVENT. We will be contacting you in a few days time to see if and when it would be convenient for one of us to meet you. Thank you.

Yours sincerely

Guide to Interviewer

[Note: Not for respondent. To be held by interviewer at all times]

Thank you for your cooperation in undertaking this investigation. These notes are intended to guide you in your role as administrator of this questionnaire.

(a) This questionnaire is to be administered during a home interview. You should sit opposite, or at right angles to your respondent, and ensure that you have a hard surface on which to lean, and a pen or pencil.

(b) You are administering the questionnaire, and therefore have a part to play in controlling the pace at which it is completed. Do not rush the respondent. Furthermore, do not let the respondent rush you. It is not a speed or comprehension test, but an instrument of scientific investigation. You should avoid giving the impression that you are quizzing or analysing the respondent, and should not encourage him to think he is involved in a competition.

(c) You should put the respondent at his ease by starting with the following words:

"Thank you very much for agreeing to complete this questionnaire. It is part of a study being

/conducted

<u>conducted by staff of the Economics Department of the University of Edinburgh. As such, the investigation has no affiliation with any other body, institution, agency or any organization whatsoever, and the material is gathered in strict confidence. The identity of you or your firm as such will not be revealed in the study: nor is it of any relevance to the study. We would ask your permission that the data we gather may be used in an anonymous way for purely scientific purposes. If at the end of the questionnaire you have any general questions you would like to raise, I would be happy to answer them."</u>

(d) The questionnaire is made up of four types of material, which are all appropriately colour-coded: (i) the <u>questionnaire</u> proper, which is in <u>white</u>; (ii) <u>lists</u>, which are to be handed to the respondent for self-completion, and are in <u>yellow</u>; (iii) <u>show cards</u>, which are also to be handed to the correspondent for self completion and are in <u>pink</u>; and (iv) <u>standard industrial classification</u> (SIC) numbers which are in <u>blue</u> and have to be handed to the respondent at the beginning of the interview in order that he can identify his own SIC number.

/ (e)

(e) At the end of the interview <u>all</u> material should be back in your hands. As you progress through the questionnaire schedule, you will find your instructions in square brackets. Do not deviate from these instructions. In particular, make sure that you do retrieve material which has been handed to the respondent: <u>in the sequence indicated</u>.

(f) At the end of the interview you should ensure that you have:

(i) Gathered all the material together, and picked up your personal belongings.

(ii) Warmly thanked the respondent for his cooperation and helpfulness.

(iii) Assured the respondent that you would be happy to be contacted by him at an address you are willing to leave (make it the Economics Department).

(iv) Suggested that, should he be willing, it might be helpful to approach him again at a later date.

(g) The motivation for f(iv) above is that the follow-ups to this questionnaire analysis are structured interviews, and then a limited number of case studies. It would be appropriate to mention this at the end of the interview, but this is not a matter that should be pressed. If the respondent volunteers further cooperation, assure him you will be in contact to

/advise

advise him as to whether his help might be needed again.

(h) At the beginning of the questionnaire you expressed a willingness to be questioned further, at the end of the interview, in a general sense. You should be willing to do this, as promised, but should not prompt the respondent. Time is limited, and you may start off issues in areas which, if pursued too much, will leave you adrift. Be businesslike, but courteous. A good exiting excuse is that you have a further person to interview.

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Name of interviewer: ....

Date of interview: ....

Time interview started: ....

Part 1 (GENERAL)

This questionnaire is divided up into five sections: a general one; pricing; costs; sales and competition; and financing. The typical way in which we will proceed will involve my asking a question, and then noting your reply. In addition there are a number of lists from which you will be asked to choose options, and then rank them; and also "show cards" which depict various patterns of costs, from which I would like you to make a selection. It is helpful to begin in a general way. This will help us to identify the main features of your business, before going into detail. May we begin then with the general questions?

Part 1 (GENERAL)

1.1 We need to know what kind of business you run. An easy way to do this is to refer to a standard list. Here it is.

[Hand over SIC list]

In which category is your business?

[Enter SIC code] SIC code ....

1.2 When did you start your business? ....

1.3 Could you tell me, how many people are working for you full time?.....

1.3.1

Do you have any part time workers?

Yes [ ]

No [ ]

1.3.1.1

<u>If yes</u>: How many? .....

1.3.2:

What about trainees?

Yes [ ]

No [ ]

1.3.2.1

<u>If yes</u>: How many? .....

1.4 What kind of business do you run? Is it:

[Tick appropriate choice]

(a) a one-man business? [ ]

(b) a partnership? [ ]

(c) a private company? [ ]

(d) a public company? [ ]

(e) or is it something else? [ ]

1.4.1

<u>If (e)</u> Could you briefly describe your kind of business?

[Enter respondent's reply]

1.5 <u>Approximately</u> what size was your sales turnover in the last tax year (excluding VAT)? ....

1.6 Suppose you sold different kinds of hats and and also different kinds of gloves.

Then "hats" is what we call a product group and so is "gloves".

How many product groups do you sell?

(a) One [ ]

(b) 2-5 [ ]

(c) 6-10 [ ]

(d) 11-20 [ ]

(e) 21-50 [ ]

(f) More than 50 [ ]

1.6.1 What would you say was your main product group in terms of sales value? ....

[Before proceeding to 1.7, insert in 1.9 the respondent's reply to this question.]

1.7 If you sold two kinds of hats (like bowlers and boaters), hats being a product group, and two kinds of gloves (like mittens and driving gloves), gloves being a product group, you would be selling a total of four products, two from each product group. With this in mind, how many products do you sell?

(a) 1-10 [ ]

(b) 11-20 [ ]

(c) 21-40 [ ]

(d) 41-60 [ ]

(e) 61-80 [ ]

(f) More than 80 [ ]

1.8 What do you regard as the principal market for your main product group?

(a) The local community [ ]

(b) The region (e.g. Grampian, Lothian) [ ]

(c) Scotland [ ]

(d) The U.K. [ ]

(e) The international economy [ ]

1.9 In terms of your principal market, what is your market share for ....

[Insert respondent's specified main product group from 1.6.1.]

[Tick below according to respondent's reply]

(a) Under 1% [ ]

(b) 1-5% [ ]

(c) 6-10% [ ]

(d) 11-20% [ ]

(e) 21-30% [ ]

(f) 31-50% [ ]

(g) Over 50% [ ]

(h) Not known [ ]

1.10 Can you distinguish between major and minor competitors for your main product group?

Yes [ ] If yes go to 1.10.1

No [ ] If no go to 1.10.2

1.10.1 [To be answered if above response was yes]

How many competitors do you have in each category?

Major competitors			Minor competitors		
(a)	None	[ ]	(a)	None	[ ]
(b)	1-5	[ ]	(b)	1-5	[ ]
(c)	6-10	[ ]	(c)	6-10	[ ]
(d)	11-30	[ ]	(d)	11-30	[ ]
(e)	31-50	[ ]	(e)	31-50	[ ]
(f)	More than 50	[ ]	(f)	More than 50	[ ]
(g)	Do not know	[ ]	(g)	Do not know	[ ]

1.10.2 [To be answered if above response was no]

Can you tell me how many competitors you have?

(a) None

(b) 1-5

(c) 6-10

(d) 11-30

(e) 31-50

(f) More than 50

(g) Do not know

1.11 How would you compare products in your main product group with those of your competitors? Would you say they were:

(a)	Identical	[ ]
(b)	Similar	[ ]
(c)	Different	[ ]
(d)	Cannot say	[ ]

1.12 Now I would like to look at the buying behaviour of your customers. Here is a list of possible descriptions of your customers. More than one may be applicable.

[Hand over List 1.12 to respondent]

Indicate with a tick <u>any</u> statement which applies to your customers

[Pause to permit completion of this]

1.12.1

Now could you please underline the statement that is <u>most</u> applicable

[Retrieve List 1.12]

Part 2 (PRICING)

Thank you. Now we have finished the general questions. Next we are going to look at pricing. In this section I will be presenting you with further lists, from which you will have to choose options and rank alternatives.

Part 2 (PRICING)

2.1 If you brought a new product onto the market, would you determine its price independently of the amount to be sold?

Yes [ ]

No [ ]

2.2 How are prices within your main product group usually determined? Could you put a tick by <u>any</u> statement on this list which is true for you?

One or more of the statements may be applicable.

[Hand over List 2.2 to respondent. Pause to permit completion of this]

2.2.1

Now please underline the statement on this list which is <u>most</u> applicable.

[Retrieve List 2.2]

2.3 Is the pricing policy of competitors crucial to your own pricing?

Yes [ ]

No [ ]

2.4 Do you hold down price to beat your competitors?

Yes [ ]

No [ ]

2.5 What action do you take when a boom in demand occurs and this demand cannot be met from stocks. On this list, please tick any that apply.

[Hand over List 2.5. Pause to permit its completion]

2.5.1

Now please indicate where possible on this list, the order in which you do things by ringing the numbers on the right hand side, where ringing a 1 for an option would indicate that this is what you would do first.

[Pause to permit completion. Retrieve List 2.5]

2.6 What action do you take in a recession? On this list, please tick those that apply.

[Hand over List 2.6. Pause to permit its completion]

2.6.1

As previously, could you please indicate where possible on this list, the order in which you do things by ringing the numbers on the right hand side.

[Pause to permit completion. Retrieve List 2.6]

2.7 What action do you take if the demand falls for a product within your main product group? Please tick any that apply on this list.

[Hand over List 2.7 to respondent. Pause to permit completion of it]

2.7.1

Indicate where possible, on this list, the order in which you do things by ringing the numbers on the right hand side.

[Pause to permit completion. Retrieve List 2.7]

Part 3 (COSTS)

Fine. We have finished with pricing. Now in just the same way we will look at costs. All the questions relate to products in your main product group. In this section we will be using the "show cards" I mentioned earlier, which present various possible pictures of your costs.

3.1 Are your costs split up into fixed (that is, overhead, or indirect) and variable (that is, prime or direct) costs?

Yes [ ]

No [ ]

3.1.1 <u>If yes</u>:

Are these cost divisions useful in the running of your firm?

Yes [ ]

No [ ]

3.2 When you intend to increase the output of a product, do you calculate the additional cost it will involve?

Yes [ ]

No [ ]

3.3 Do you have a level of output which you regard as the <u>capacity</u> or <u>maximum possible</u> output?

Yes [ ]

No [ ]

3.3.1 <u>If yes</u>:

At what percentage of this maximum possible output do you think you normally operate?

(a) Less than 50% [ ]

(b) 51-60% [ ]

(c) 61-70% [ ]

(d) 71-80% [ ]

(e) 81-90% [ ]

(f) 91-100% [ ]

3.4 This next question aims to get an idea of the way your costs vary as you increase your output up to the maximum level possible. Could you examine the cost pictures on these sheets and hand to me any which approximate to your cost pattern?

[Hand respondent show-cards 3.4(a) to 3.4(e)]

Underneath each picture you will find an explanation in words which you may prefer to use in making your choices. Please ask me if the pictures are not entirely clear.

[Pause for selection to take place. Retrieve selected sheets, and note below the selections made]

(a) [ ] (b) [ ] (c) [ ] (d) [ ] (e) [ ]

[Retrieve remaining sheets]

Part 4 (SALES and COMPETITION)

Good. We are now half-way through. Next we will look at sales and competition. Questions will again refer to products in your main product group.

Part 4 (SALES and COMPETITION)

4.1 Does your enterprise use market research methods of any kind, including forecasts by official bodies, trade associations etc.?

Yes [ ]

No [ ]

4.1.1

<u>If yes</u>: For what purposes are the results of market research used?

(a) To find out how important price changes are to customers [ ]

(b) To find out how interested buyers are in your products [ ]

(c) To find out the reaction of competitors [ ]

(d) To get an idea of future developments in the market [ ]

4.2 How would your sales react to a 5% price change, where it is assumed that your competitors do not react and that business conditions are normal? We will look at the consequences of a price cut and a price increase separately.

4.2.1 For a price cut of 5% the amount purchased would:

(a) increase more than 5% [ ]

(b) increase less than 5% [ ]

(c) increase by approximately 5% [ ]

(d) not increase at all [ ]

(e) possibly increase, possibly not. One cannot say. [ ]

4.2.2 For a price increase of 5% the amount purchased would:

(a) fall more than 5% [ ]

(b) fall less than 5% [ ]

(c) fall by approximately 5% [ ]

(d) not fall at all [ ]

(e) possibly fall, possibly not. One cannot say. [ ]

4.3 What about a 10% price change? Again let's assume normal business conditions and no reaction on the part of your competitors.

4.3.1 For a price cut of 10% the amount purchased would:

(a) increase more than 10% [ ]

(b) increase less than 10% [ ]

(c) increase by approximately 10% [ ]

(d) not increase at all [ ]

(e) possibly increase, possibly not. One cannot say. [ ]

4.3.2 For a price increase of 10% the amount purchased would:

(a) fall more than 10% [ ]

(b) fall less than 10% [ ]

(c) fall by about 10% [ ]

(d) not fall at all [ ]

(e) possibly fall, possibly not. One cannot say. [ ]

4.4 If you <u>reduce</u> your price do you reckon that your strongest competitors will do the same and reduce their prices, first of all

4.4.1 In normal business conditions?

Yes [ ]

No [ ]

Don't know [ ]

and now

4.4.2 In a boom?

Yes [ ]

No [ ]

Don't know [ ]

and finally

4.4.3 In a recession?

Yes [ ]

No [ ]

Don't know [ ]

4.5 Do you reckon that your competitors would <u>raise</u> their prices if you <u>increased</u> your price, first of all

4.5.1 In normal business conditions?

Yes [ ]

No [ ]

Don't know [ ]

and now

4.5.2 In a boom?

Yes [ ]

No [ ]

Don't know [ ]

and finally

4.5.3 In a recession?

Yes [ ]

No [ ]

Don't know [ ]

4.6 Do you believe that you have a certain amount of "elbow-room" in pricing, within which a price change by you does not bring about a reaction from competitors?

Yes [ ]

No [ ]

Don't know [ ]

4.6.1

If yes:

How large is this "elbow-room" in percentage terms?

(a) 1% [ ]

(b) 2-3% [ ]

(c) 4-6% [ ]

(d) 7-9% [ ]

(e) 10-15% [ ]

(f) more than 15% [ ]

(g) do not know [ ]

4.7 On this list various ways in which you can alter your selling price are mentioned. Tick any that apply to you.

[Hand over List 4.7. Pause to permit respondent to complete it. Retrieve List 4.7]

4.8 Do you ever sell at <u>different</u> prices goods which cost the <u>same</u>?

Yes [ ]

No [ ]

4.8.1 <u>If yes:</u>

Are these prices set:

(a) in different marketing areas [ ]

(b) in home and foreign markets [ ]

(c) for different customers [ ]

(d) for large and small traders [ ]

(e) Other [ ]

If (e), please specify if possible

4.9 Do you ever offer price rebates?

Yes [ ]

No [ ]

4.9.1 <u>If yes</u>:

Are rebates higher, the greater the amount purchased (that is, do you practice bulk discounting)?

Yes [ ]

No [ ]

4.10 Are any of your goods sold at controlled prices?

Yes [ ]

No [ ]

4.11 Are any of your goods sold at recommended prices?

Yes [ ]

No [ ]

4.11.1 <u>If yes</u>:

What percentage of your customers end up paying the recommended price?

(a) Less than 30% [ ]

(b) 31-60% [ ]

(c) 61-80% [ ]

(d) 81-90% [ ]

(e) 91-100% [ ]

(f) Do not know [ ]

4.12 Do you advertise? Yes [ ]

No [ ]

4.12.1 <u>If yes</u>:

What form does your advertising take?

(a) Generic advertising, that is, advertising aimed at expanding demand for all firms in the industry [ ]

(b) Individual advertising, that is, advertising aimed at promoting your product over that of rivals [ ]

(c) Both generic and individual advertising [ ]

4.13 Do you increase your advertising when business demand is low?

Yes [ ]

No [ ]

Don't know [ ]

4.14 Do you reduce your advertising when there is a boom?

Yes [ ]

No [ ]

Don't know [ ]

4.15 How would you describe competition in your market?

(a) Intense in every aspect (price, quality, rivalry etc.) [ ]

(b) Generally strong, but weak in some aspects (for example, absence of price competition, but strong quality competition and inter-firm rivalry) [ ]

(c) Generally weak, but strong in some aspects [ ]

[If (c) is ticked, go to 4.15.1 below]

(d) Generally weak in all its aspects [ ]

4.15.1 [To be answered if (c) is ticked in 4.15 above]

In your market is the dominant form of competition by:

(a) Price [ ]

(b) Quality [ ]

(c) Sales [ ]

(d) Market Share [ ]

(e) Advertising [ ]

(f) Other [ ]

If (f), please specify:

Part 5 (FINANCE)

Excellent. We have made very good progress. Now we turn to the last part of the questionnaire, on finance.

Part 5 (FINANCE)

5.1 Did you contact anyone for advice on how to get your business started?

Yes [ ]

No [ ]

If no: go to 5.2.

5.1.1 If yes:

Who did you contact for advice on how to get your business started? On this list various sources of of advice are described.

[Hand respondent List 5.1.1]

Could you indicate with a tick any source which applied to you?

[Pause to permit completion of this]

5.1.1.1

Now could you please rank in order of importance the various alternatives, using the numbers on the right of the listed sources.

[Pause to permit completion. Retrieve List 5.1.1]

5.2 What was the approximate size of your business in terms of total assets (book value) when you started? ....

5.3 What is the approximate size of your business today in terms of total assets (book value)? ....

5.4 Did you find it difficult to obtain financial support for starting your business?

Yes	[ ]
No	[ ]

<u>If no</u>: Go to 5.5

5.4.1 <u>If yes</u>:

What were the obstacles in obtaining financial support? On this list please tick <u>all</u> those that apply.

[Hand over List 5.4.1, pause to permit its completion]

5.4.1.1

Now please rank the obstacles in order of importance by ringing the numbers on the right hand side. The most significant obstacle should have a 1 ringed, the second most significant a 2 ringed and so on.

[Pause to permit completion. Retrieve List 5.4.1]

5.5. Did you use only personal finances to set up your business?

	Yes	[ ]
	No	[ ]

<u>If yes</u>: Go to 5.6

5.5.1 <u>If no</u>:

What other sources did you use? On this list, indicate with a tick any statement which is applicable to you.

[Hand over List 5.5.1 to respondent. Pause to permit its completion]

5.5.1.1

Now could you indicate the importance of these sources by ringing the numbers on the right hand side. The most important should have a 1 ringed, the next most important a 2 ringed and so on.

[Pause to permit completion. Retrieve List 5.5.1]

5.5.2

What sort of security did you have to provide in seeking funds? Tick any that apply on this list.

[Hand over List 5.5.2. Pause to permit its completion. Retrieve List 5.5.2.]

5.6 <u>Gearing</u> is a technical term you may have come across which means debt (i.e. borrowing) divided by owners' injection of finance. So if you borrowed £10,000 and put in £20,000 yourself your gearing ratio would be 10,000 divided by 20,000: that is one half. What, approximately speaking, was your gearing ratio when you set up the business?

Enter gearing ratio figure ....

5.6.1

What is your gearing ratio at present? ....

5.6.2

What has been your highest gearing ratio? ....

5.6.3

And what has been your lowest gearing ratio? ....

5.7 What do you expect to happen to your gearing ratio in the course of the next three years? Will it:

	Fall	Rise	Stay the Same	Don't Know
(a) After 1 year	[ ]	[ ]	[ ]	[ ]
(b) After 2 years	[ ]	[ ]	[ ]	[ ]
(c) After 3 years	[ ]	[ ]	[ ]	[ ]

[Fill in responses to a, b, c above in List 5.7.1 also]

5.7.1

Why do you expect your gearing ratio to behave the way you have indicated, over the next three years? Please tick all that apply on this list.

[Hand respondent List 5.7.1. Pause to permit its completion. Retrieve List 5.7.1]

5.8 Were the following special financial schemes necessary, helpful, or not applicable to the starting up of your business?

		Necessary	Helpful	Not Applicable
(a)	Enterprise allowance scheme	[ ]	[ ]	[ ]
(b)	Employment grant	[ ]	[ ]	[ ]
(c)	Investment grant	[ ]	[ ]	[ ]
(d)	Reduced rental on premises	[ ]	[ ]	[ ]
(e)	Special tax credits	[ ]	[ ]	[ ]
(f)	Other	[ ]	[ ]	[ ]

If (f), please specify, if possible:

5.9 Have you ever had cash-flow difficulties?

Yes [ ]

No [ ]

<u>If no</u>: go to 5.10

5.9.1 <u>If yes</u>:

What factors on this list contributed to your cash-flow difficulties? Please tick all those that apply.

[Hand respondent List 5.9.1. Pause to permit completion of it]

5.9.2

Indicate if possible the relative importance of these factors by ringing the numbers on the right hand side. The most significant factor should be ranked as 1, the next most significant as 2, and so on.

[Pause to permit completion. Retrieve List 5.9.1]

5.10 Have you used external finance (e.g. debt) since starting your business?

Yes	[ ]
No	[ ]

<u>If no</u>: go to 5.11.

5.10.1 <u>If yes</u>:

What were your reasons for wishing to increase your external finance ?. On this list, please tick any that apply.

[Hand respondent List 5.10.1 Pause to permit completion of list. Retrieve List 5.10.1]

5.11 Do you expect growth in your business over the foreseeable future?

Yes	[ ]
No	[ ]
Don't know	[ ]

[Read the following to respondent]

That is the end of the questionnaire. Thank you for completing it. I hope you have also derived some interest yourself from doing so. Your time and co-operation are very much appreciated. Let me remind you that the strictest confidentiality will be upheld regarding the information you have provided about your business. If you should be interested in our general findings regarding the development of small businesses, we will be more than happy to share these results. We hope that our research will contribute to the success and growth of small businesses. We wish you all the very best with your firm.

Time interview completed ....

Signature of interviewer ....

SIC Classification Numbers

01	Agriculture and horticulture
02	Forestry
03	Fishing
11	Coal extraction and manufacture of solid fuels
12	Coke ovens
13	Extraction of mineral oil and natural gas
14	Mineral oil processing
15	Nuclear fuel production
16	Production and distribution of electricity, gas and other forms of energy
17	Water supply industry
21	Extraction and preparation of metalliferous ores
22	Metal manufacturing
23	Extractions of other minerals
24	Manufacture of non-metallic mineral products
25	Chemical industry
26	Production of man-made fibres
31	Manufacture of other metal goods
32	Mechanical engineering
33	Manufacture of office machinery and data processing equipment
34	Electrical and electronic engineering
35	Manufacture of motor vehicles and parts
36	Manufacture of other transport equipment
37	Instrument engineering
41/42	Food, drink and tobacco manufacturing
43	Textile industry
44	Manufacture of leather and leather goods
45	Footwear and clothing industries
46	Timber and wooden furniture industries

/47

47	Manufacture of paper and paper products; printing and publishing
48	Processing of rubber and plastics
49	Other manufacturing industries
50	Construction
61	Wholesale distribution
62	Dealing in scrap and waste materials
63	Commission agents
64/65	Retail distribution
66	Hotels and catering
67	Repair of consumer goods and vehicles
71	Railways
72	Other inland transport
74	Sea transport
75	Air transport
76	Supporting services to transport
77	Miscellaneous transport services and storage not elsewhere specified
79	Postal services and telecommunications
81	Banking and finance
82	Insurance
83	Business services
84	Renting of movables
85	Owning and dealing in real estate
91	Public administration, national defence and compulsory social security
92	Sanitary services
93	Education
94	Research and development
95	Medical and other health services: veterinary services

/ 96

96 Other services provided to the general public

97 Recreational services and other cultural services

98 Personal services

99 Domestic services

Now I would like to look at the buying behaviour of your customers. Here is a list of possible descriptions of your customers. More than one may be applicable.

Could you indicate with a tick any statement which applies to your customers.

(a) Technical differences between our products and those of our rivals are too small for our customers to distinguish. Price, brand, design, advertising intensity, packaging, and service all determine the customers' attitude. [ ]

(b) The customer is not technically minded but may have in mind a few technical features that the product should have. [ ]

(c) Before making a purchase, the customer needs to be informed on the technical features of a product, and is guided by such factual matters. [ ]

(d) The customer is fairly expert about the product concerned and can draw on personal experience as well as technical information available in specialist publications, trade journals etc. [ ]

(e) The customer is an expert and can determine by his own judgment the technical quality of the product. [ ]

Now go back and underline the statement that is most applicable.

<u>List 2.2</u>

How are prices within your main product group usually determined? One or more of the following statements may be applicable.

Put a tick by <u>any</u> statement which is true for you.

(a) Price is made up of direct (i.e. prime, or variable) cost per unit plus a fixed percentage mark-up. The mark-up is set at a level designed to achieve a desired level of gross profit. [ ]

(b) Price is based on direct (i.e. prime, or variable) cost per unit, as in (a) above, but the percentage mark-up is not fixed: it may be raised (or lowered) to increase gross profit. [ ]

(c) Price is set at the highest level the market can bear. [ ]

(d) Price is specified by your principal customer. [ ]

(e) Price is determined by a regulatory agency. [ ]

(f) Price is set at a statutory level. [ ]

(g) Price is determined in other ways. [ ]

If (g), please say how:

<u>Now please underline the statement which is most applicable to you.</u>

<u>List 2.5</u>

What action do you take when a boom in demand occurs and this demand cannot be met from stocks?

Please tick any that apply:

(a)	Increase overtime or shift work	[ ]	1	2	3	4	5	6	7
(b)	Increase capacity (this could include the recruitment of more personnel)	[ ]	1	2	3	4	5	6	7
(c)	Engage subcontractors	[ ]	1	2	3	4	5	6	7
(d)	Buy up rival firms	[ ]	1	2	3	4	5	6	7
(e)	Lengthen your order books	[ ]	1	2	3	4	5	6	7
(f)	Raise price	[ ]	1	2	3	4	5	6	7
(g)	Other	[ ]	1	2	3	4	5	6	7

If (g), please specify, if possible.

Indicate where possible the order in which you do things by ringing the numbers on the right hand side, where ringing a 1 for any option would imply that this is what you would do first.

List 2.6

What action do you take in a recession?

On this list, please tick those that apply:

(a)	Reduce overtime	[ ]	1	2	3	4	5	6	7	8
(b)	Introduce short-time working	[ ]	1	2	3	4	5	6	7	8
(c)	Reduce capacity (including the laying-off of personnel)	[ ]	1	2	3	4	5	6	7	8
(d)	Improve productivity or efficiency	[ ]	1	2	3	4	5	6	7	8
(e)	Increase sales effort	[ ]	1	2	3	4	5	6	7	8
(f)	Cut price	[ ]	1	2	3	4	5	6	7	8
(g)	Reduce stockholding	[ ]	1	2	3	4	5	6	7	8
(h)	Other	[ ]	1	2	3	4	5	6	7	8

If (h), please specify, if possible.

Now please indicate, where possible, the order in which you do things by ringing the numbers on the right hand side.

List 2.7

What action do you take if the demand falls for a particular product within your main product group?

Please tick any that apply on this list.

(a)	Switch to a new product	[ ]	1	2	3	4	5	6	7
(b)	Reduce overtime	[ ]	1	2	3	4	5	6	7
(c)	Introduce short-time working	[ ]	1	2	3	4	5	6	7
(d)	Increase sales effort	[ ]	1	2	3	4	5	6	7
(e)	Cut price	[ ]	1	2	3	4	5	6	7
(f)	Increase quality	[ ]	1	2	3	4	5	6	7
(g)	Other	[ ]	1	2	3	4	5	6	7

If (g), please specify, if possible.

Now please indicate, where possible, the order in which you do things by ringing the numbers on the right hand side.

<u>List 4.7</u>

On this list, events which might lead you to alter your selling price are mentioned.

Which options on this list refer to you?

(a) When a new business year (or new season of production) commences [ ]

(b) When a new tax year commences [ ]

(c) When cost changes occur [ ]

(d) When demand shifts substantially [ ]

(e) When demand changes [ ]

(f) When a regulatory agency permits an increase [ ]

(g) When wage bargaining negotiations in the firm or in the industry have been concluded [ ]

(h) When the most important competition changes price [ ]

(i) Other [ ]

If (i), specify if possible:

List 5.1.1

Who did you contact for advice on how to get your business started?

On this list, indicate with a tick any source which applies to you.

(a)	Family and/or friends	[ ]	1	2	3	4	5	6	7
(b)	Bank manager	[ ]	1	2	3	4	5	6	7
(c)	Accountant	[ ]	1	2	3	4	5	6	7
(d)	Enterprise trust	[ ]	1	2	3	4	5	6	7
(e)	Scottish Development Agency (SDA)	[ ]	1	2	3	4	5	6	7
(f)	Local government authority	[ ]	1	2	3	4	5	6	7
(g)	Other	[ ]	1	2	3	4	5	6	7

If (g), please specify:

Now please indicate, where possible, the relative importance of these various alternative contacts for advice. The most important should have a 1 ringed, the second most important a 2 ringed and so on.

<u>List 5.4.1</u>

What were the obstacles in obtaining financial support?

Put a tick by any statement which is true for you.

(a)	Lack of personal financial injections	[ ]	1	2	3	4	5	6
(b)	Establishing the idea that a market existed for your products	[ ]	1	2	3	4	5	6
(c)	Lack of success in previous business venture(s)	[ ]	1	2	3	4	5	6
(d)	Difficulty in producing satisfactory financial statements of proposed business (e.g. projected cash flow budget)	[ ]	1	2	3	4	5	6
(e)	Previous employment experience	[ ]	1	2	3	4	5	6
(f)	Other	[ ]	1	2	3	4	5	6

If (f), please specify:

Now indicate, if possible, the extent of the various obstacles by ringing the numbers on the right hand side. The biggest obstacle should have a 1 ringed, the second biggest the 2 ringed and so on.

List 5.5.1

What sources of finance, apart from personal finance, did you use in setting up your business?

On this list, indicate with a tick any statement which applies to you.

(a)	Borrowing from friends, relatives or acquaintances	[ ]	1	2	3	4	5	6
(b)	Borrowing from banks	[ ]	1	2	3	4	5	6
(c)	Hire purchase	[ ]	1	2	3	4	5	6
(d)	Leasing	[ ]	1	2	3	4	5	6
(e)	Equity finance	[ ]	1	2	3	4	5	6
(f)	Other	[ ]	1	2	3	4	5	6

If (f) please specify, if possible.

Now please indicate, where possible, the importance of these various alternative sources of finance. The most important should have a 1 ringed, the second most important a 2 ringed and so on.

List 5.5.2

What sort of security did you have to provide in seeking funds?

Tick any that apply on this list.

(a)	Personal guarantee (implying a liability to repay loans)	[ ]
(b)	Life policies	[ ]
(c)	Guarantors	[ ]
(d)	Stock exchange securities	[ ]
(e)	Heritable securities (e.g home, property, premises, land)	[ ]
(f)	Floating charges (i.e. securities on plant, equipment, stocks etc.)	[ ]
(g)	Other	[ ]

If (g), please specify if possible:

List 5.7.1

In the question which we have been considering you indicated that your gearing ratio would behave as follows in the course of the next three years:

		Fall	Rise	Stay the Same	Don't Know
(a)	After 1 year	[ ]	[ ]	[ ]	[ ]
(b)	After 2 years	[ ]	[ ]	[ ]	[ ]
(c)	After 3 years	[ ]	[ ]	[ ]	[ ]

Why do you expect your gearing ratio to behave like this? Please tick any that apply:

		After 1 year	After 2 years	After 3 years
(a)	An increase in ploughed-back profits	[ ]	[ ]	[ ]
(b)	An increase in owners' injections	[ ]	[ ]	[ ]
(c)	An increase in debt (i.e. borrowing)	[ ]	[ ]	[ ]
(d)	Running at a loss	[ ]	[ ]	[ ]
(e)	A reduction in debt (i.e. borrowing)	[ ]	[ ]	[ ]
(f)	No certain answer	[ ]	[ ]	[ ]
(g)	Other	[ ]	[ ]	[ ]

If (g), please specify, if possible.

List 5.9.1

What factors contributed to your cash-flow difficulties? Please tick any that apply:

(a)	Delinquent debtors	[ ]	1	2	3	4	5	6	7
(b)	Delinquent suppliers	[ ]	1	2	3	4	5	6	7
(c)	Overinvestment (e.g. in stock or capital goods)	[ ]	1	2	3	4	5	6	7
(d)	Inadequate credit policy with buyers	[ ]	1	2	3	4	5	6	7
(e)	Inadequate credit policy with suppliers	[ ]	1	2	3	4	5	6	7
(f)	Insufficient overdraft facility	[ ]	1	2	3	4	5	6	7
(g)	Other	[ ]	1	2	3	4	5	6	7

If (g), please specify if possible:

Now indicate, if possible, the relative importance of these factors by ringing the numbers on the right hand side. The most significant should be ranked 1, the next most significant 2, and so on.

List 5.10.1

What were your reasons for wishing to increase your external finance?

On this list, please tick any that apply.

(a)	New or expanded premises	[ ]
(b)	Purchase of plant or equipment	[ ]
(c)	Increased stock or inventory	[ ]
(d)	Hiring of new employees	[ ]
(e)	Cash flow problems	[ ]
(f)	Other	[ ]

If (f), please specify if possible.

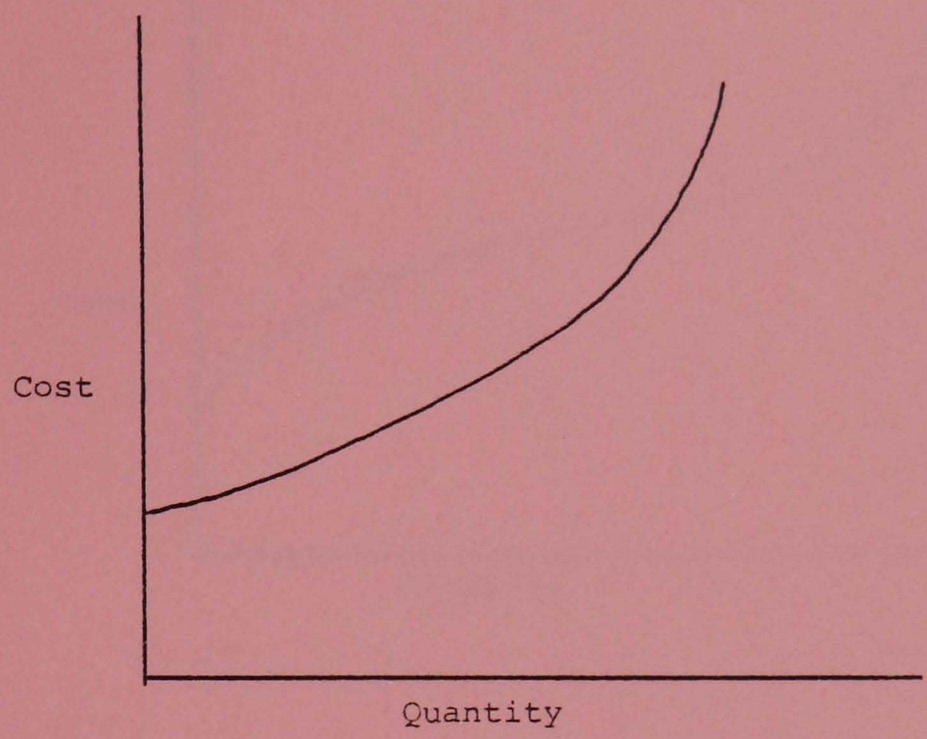
Show-Card 3.4 (a)

(a) Total cost increases in line with amount supplied i.e. for each extra unit supplied, your cost rises by the same extra amount.

Show-Card 3.4 (b)

(b) Total cost does not increase as fast as amount supplied i.e. the extra cost of supplying each additional unit falls as more is supplied.

Show-Card 3.4 (c)

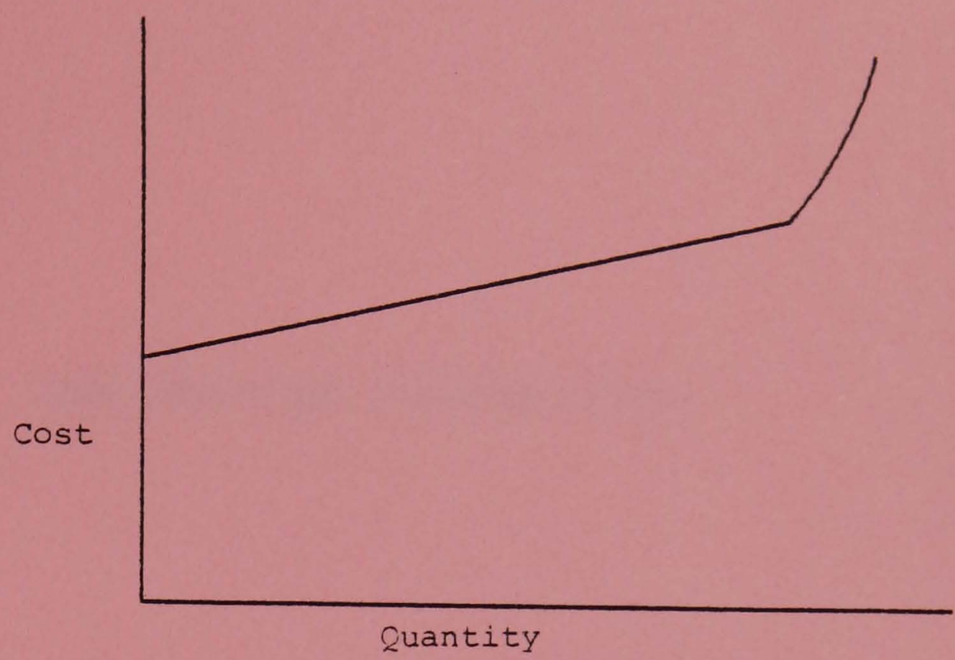


(c) Total cost increases faster than supply i.e. each extra unit supplied adds more to cost than the last unit supplied.

Show-Card 3.4 (d)

(d) At first total cost does not increase as fast as supply, but then it increases faster than supply.

Show-Card 3.4 (e)



(e) Total cost increases in line with supply until the maximum possible supply (full capacity) is reached. After this point, the extra cost of supplying another unit rises sharply.

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(WHITE) FRONTPIECE

SEMI-STRUCTURED INTERVIEW AGENDA

Name of interviewer: . . . .

Interviewee code: . . . .

Date of interview: . . . .

Time interview started: . . . .

(WHITE)

PRE-AMBLE

[The content of this pre-amble should be explained to the interviewee]

PRE-AMBLE

Thank you for agreeing to this further interview. The same basis of strict confidentiality continues to apply. Last time the interview was concerned with very specific questions which could be answered by "yes" or "no", by ticking alternatives, by ranking options etc. Today, the approach is less structured. I have a number of areas which I would like to look at with you, all of which are concerned with general aspects of business strategy.

Strategy involves adapting the capabilities and resources of your firm to the opportunities in its market environment. We will explore strategy in terms of a list of headings, or agenda, and this outline should help to give you a general idea of how the interview will proceed.

[Hand respondent the agenda outline overleaf]

(WHITE)

AGENDA OUTLINE: RESPONDENT'S COPY

AGENDA OUTLINE

1 <u>Competitive Forces</u>

1.1 Rivalry

1.2 Customers

1.2.1 Bargaining leverage of customers

1.2.2 Price sensitivity of customers

1.3 Suppliers

1.4 Potential entrants

1.5 Substitutes

2 <u>Competitive Strategy</u>

2.1 Cost Leadership

2.2 Differentiation

2.3 Focus

3 <u>Defensive Strategy</u>

3.1 Increasing barriers to entry

3.2 Increasing retaliation which challengers can expect

3.3 Lowering the inducement for attack

3.4 Deterrence

3.5 Responding to attack

(WHITE)

AGENDA OUTLINE: INTERVIEWER'S COP

AGENDA OUTLINE

1 <u>Competitive Forces</u>

1.1 Rivalry

1.2 Customers

1.2.1 Bargaining leverage of customers

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2 <u>Competitive Strategy</u>

2.1 Cost leadership

2.2 Differentiation

2.3 Focus

3 <u>Defensive Strategy</u>

3.1 Increasing barriers to entry

3.2 Increasing retaliation which challengers can expect

3.3 Lowering the inducement for attack

3.4 Deterrence

3.5 Responding to attack

1 Competitive Forces

1.1 Rivalry

Probe on:
Industry concentration and balance
Industry growth
Fixed costs relative to value added
Intermittent overcapacity
Extent of product differentiation
Diversity of competitors
Level of strategic stakes
Entry and exit barriers

Field Notes:

Summary Note:

(BLUE)

COMPETITIVE FORCES

1.2 Customers

1.2.1 Bargaining leverage of customers

Probe on:

Customers' concentration

Seller dependence

Relative buyer volume

Customers' switching costs

Ability to backward integrate

Extent of customers' information

Field Notes:

Summary Note:

1.2.2 Price sensitivity of customers

Probe on:

Significance of costs in relation to total costs of customers
Extent of differentiation of products purchased
Profitability
Bearing of your product on customers' product quality
Motivation of customer

Field Notes:

Summary Note:

1.3 Suppliers

Probe on:

Extent of suppliers' concentration
Suppliers' in relation to customers' concentration
Availability of substitutes
Significance of suppliers' product as a customer's input
Extent of differentiation of supplier group's products
Switching costs of customers as compared with suppliers
Ability to forward integrate

Field Notes:

Summary Note:

(BLUE)

1.4 Potential entrants

Probe on:

Economies of scale
Product differentiation
Capital requirements
Switching costs
Access to distribution channels
Absolute cost advantages including:
- Product know-how or design characteristics
- Favourable access to inputs
- Favourable location
- Government subsidies
- Learning or experience curve

Government policy (regulation, pollution control, etc)
Expected retaliation
Entry deterring price

Field Notes:

Summary Note:

1.5 Substitutes

Probe on:

Products that perform the same function as industry's
Relative value/price of substitutes
Substitutes produced by high profit industries
Collective industry response to substitutes
Customers' propensity to substitute

Field Notes:

Summary Note:

2 Competitive Strategy

2.1 Cost leadership

Probe on:
Value chain and assignment of costs and assets
Cost drivers and their interaction
Competitor's value chain
Relative costs of competitors and their sources
Strategies to lower relative costs including:
- Control of cost drivers
- Reconfiguration of value chain
- Reconfiguration of downstream value

Trade-off between differentiation and cost reduction
Sustainability of cost reduction strategy

Field Notes:

Summary Note:

2.2 Differentiation

Probe on:

Identification of real customer

Identification of customer's value chain

Customer's purchasing criteria

Existing and potential sources of uniqueness in firm's value chain

Identification of existing and potential sources of differentiation

Value activities that create the most valuable differentiation for customers (relative to costs of differentiating)

Sustainability of differentiation strategy

Cost reduction in activities that do not affect differentiation

Field Notes:

Summary Note:

2.3 Focus

Probe on:

Whether strategy is towards cost or differentiation focus or both

Strategically relevant segments including:

- Product variety
- Customer type
- Channel (i.e. immediate buyer)
- Customer location

Significance of chosen segment(s) for competitive advantage

Interrelations among segments

Sustainability of focus against:

- Broadly targeted competitors
- Imitators
- Segment substitution

Field Notes:

Summary Note:

3 Defensive Strategy

3.1 Increasing barriers to entry

Probe on:
Filling product gaps
Blocking channel access
Raising customers' switching costs
Raising costs of product trial
Defensively increasing scale economies
Defensively increasing capital requirements
Foreclosing alternative technologies
Tying up suppliers
Raising costs of competitors' inputs
Defensively pursuing interrelationships with other firms
Encouraging government or agency policies that raise barriers
Forming coalitions to raise barriers
Forming coalitions to co-opt challengers

Field Notes:

Summary Note:

3.2 Increasing retaliation which challengers can expect

Probe on:

Signalling commitment to defend
Signalling erection of barriers
Establishing blocking positions
Matching guarantees
Raising own penalty of exit or of loss of market share
Accumulating retaliatory resources
Encouraging "good" competitors
Setting examples
Establishing defensive coalitions

Field Notes:

Summary Note:

3.3 Lowering the inducement for attack

Probe on:

Reducing profit targets

Managing competitors' assumptions

Field Notes:

Summary Note:

3.4 Deterrence

Probe on:

Choosing defensive tactics to block likely attacks
Managing the firm's image as a tough defender
Setting realistic profit expectations
Using industry scenarios to examine deterrence possibilities
Knowledge of specific sources of barriers
Anticipation of likely challengers (esp. dissatisfied competitors)
Forecasting likely avenues of attack

Field Notes:

Summary Note:

3.5 Responding to attack

Probe on:

Putting priority on early response
Investing in early discovery of moves by:
- Contact with suppliers
- Contact with advertising media
- Monitoring of attendance at trade shows
- Contact with most adventurous customers in industry
- Monitoring of technical conferences, college courses etc.

Basing response on reasons for attack
Deflecting challengers
Taking challengers seriously
Viewing response as a way to gain position
Disrupting test or introductory markets
Leapfrogging with new product or process
Litigation (e.g. patent, anti-trust suits)

Field Notes:

Summary Note:

(WHITE)

END

Time interview completed: ....

Signature of interviewer: ....

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